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October 18, 2023

Ms. Linda Bridwell
Executive Director
Public Service Commission
211 Sower Blvd.
Frankfort, KY 40601

Re: Atmos Energy Corporation:
Case No. 2023-00231

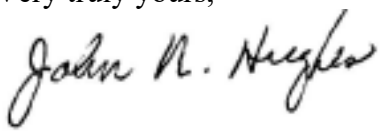
Dear Ms. Bridwell:

Atmos Energy Corporation submits its Petition for Rehearing.

I certify that the electronic filing is complete and accurate and that there are currently no parties in this proceeding that the Commission has excused from participation by electronic means.

If you have any questions about this matter, please contact me.

Very truly yours,



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COMMONWEALTH OF KENTUCKY

BEFORE THE PUBLIC SERVICE COMMISSION

IN THE MATTER OF:

Electronic Application of Atmos Energy Energy Corporation for PRP Rider Rates Beginning October 1, 2023	)))	Case No. 2023-00231

ATMOS ENERGY CORPORATION'S PETITION FOR REHEARING

Atmos Energy Corporation ("Atmos Energy" or "Company"), by counsel, pursuant to KRS 278.400, moves for rehearing of the final order dated September 29, 2023 ("Order") seeking reconsideration and clarification of certain aspects of the Order. Rehearing is sought on the following matters: 1) reconsideration of the denial of the Company's proposed Aldyl-A projects submitted in the Company's Application; 2) reconsideration of the exclusion of the Company's NOL ADIT; 3) clarification on the implementation of the $30 million capital spending cap for Pipeline Replacement Program ("PRP") investment; and 4) reconsideration for the Company to "true-up" and collect annual PRP rider revenue associated with the tariff reference period which the Commission ruled on through this Case. The requested clarifications for Items 1 through 4 could have an effect on the revenue requirement allowed and the rates approved in the Order. Atmos Energy placed the allowed rates into effect on October 1, 2023, per the Order.

1. Reconsideration of the Denial of the Company's Proposed Aldyl-A Projects Submitted in the Company's Application

First, Atmos Energy is seeking reconsideration of the denial of the Company's proposed Aldyl-A projects by the Commission in the Company's Application. In the Order, the Commission stated:

> While it indicated that the proposed Aldyl-A projects are high priority, Atmos did not indicate that the projects proposed herein ranked the highest on its DIMP or explain why they should be prioritized over specific projects that rank higher, including why the projects should be prioritized over higher ranking bare steel projects in this and subsequent years.[1]

In the Order, the Commission also stated that:

> The Commission also finds that in any future PRP application by Atmos includes a project to replace pipeline segments other than bare steel pipe, Atmos should demonstrate that the project is consistent with the evaluation and ranking of threats to its distribution system in its DIMP. Specifically, Atmos **should show either** that the Aldyl-A pipe segment is risk-ranked ahead of bare steel and other Aldyl-A pipe the replacement of which would be deferred due to the spending cap **or that specific operational circumstances justify replacement of the Aldyl-A segment ahead of higher ranked bare steel or Aldyl-A segments.[2]**

In this Case, consistent with the standard stated above, Atmos Energy presented evidence nearly identical in justification and detail as that presented to support the Aldyl-A projects included in its last general rate case (Case No. 2021-00214) and its last PRP filing (Case No. 2022-00222), and the projects were approved by the Commission in both of those prior cases. Just as the Commission found in both of those cases, the proposed Aldyl-A projects in this Case are in the public interest and should be undertaken and included in rates.

As the Commission will recall, in its order in Case No. 2022-00222, the Commission notes:

> Aldyl-A – In Case No. 2021-00214, Atmos's most recent rate case, the Commission found that inclusion in the PRP of future Aldyl-A pipeline replacements will be determined on a case-by-case basis and any PRP Applications including Aldyl-A projects should at minimum provide safety justifications for such projects. Atmos proposed to include three Aldyl-A projects in the PRP in this matter, two in Cadiz, Kentucky and one in St. Charles, Kentucky. Aldyl-A leak rates per 100 miles remain higher than coated steel and polyethylene pipe but lower than bare steel. Atmos stated that the three proposed projects for Aldyl-A replacement are predominantly pre-1973 Aldyl-A pipe, which has the highest risk of failure of the Aldyl-A family, and the tracer wire has degraded to the extent that third-part (sic.) damage risk is higher than bare steel.
>
> Atmos stated that it ranks pipe segments identified for replacement based on historical trends and current data from the past year. This ranking list changes from year to year due to population density, new facilities being installed, or ongoing record reviews. Atmos stated that Cadiz's rocky soil conditions increases the fracture risk for Aldyl-

[1] Case No. 2023-00231, *Electronic Application of Atmos Energy Corporation for PRP Rider Rates Beginning October 1, 2023* (Ky. PSC September 29, 2023), Order at 17.
[2] *Id.* at 18 (emphasis added).

> A pipe and the entire system is pre-1973 Aldyl-A. ***After the proposed projects, Atmos estimated that there are approximately six to seven more projects of similar scope and scale that would be targeted in the next two to three years.*** The proposed project in St. Charles will replace all Aldyl-A pipe in the town, which was installed in 1969. Atmos stated that while St. Charles does not have the rocky soil conditions present in Cadiz, the St. Charles pipeline has shallow soil cover and its leakage and damage history have led to one of the highest risks of failure on Atmos's system. The Commission finds the proposed Aldyl-A projects reasonable and therefore approves their inclusion in Atmos's PRP.[3]

The projects included in this year's PRP filing are among those "approximately six to seven more projects" to which the Commission alluded in its last order, and virtually the same facts and evidence were submitted by Atmos Energy to support these projects as the Aldyl-A projects approved in the last case. Thus, Atmos Energy has met the standard set in the Order "…**that specific operational circumstances justify replacement of the Aldyl-A segment ahead of higher ranked bare steel or Aldyl-A segments."** This standard is consistent not only with the Commission's past orders in Atmos Energy dockets but also in similar proceedings for other utilities.[4]

This standard does not mandate that replacement be based on highest risk as the Commission has imposed in this Order. Indeed, the "highest risk" standard established in this Order is inconsistent with the Commission's prior order in Case 2021-00214. In that case, the Commission advised Atmos Energy that "…the inclusion of future Aldyl-A pipelines will be determined on a **case-by-case** basis and any PRP applications including Aldyl-A projects should **at minimum include safety**

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[3] Case No. 2022-00222, *Electronic Application of Atmos Energy Corporation to Establish PRP Rider Rates for the Twelve Month Period Beginning October 1, 2022* (Ky. PSC May 25, 2023), Order at 2-3 (citations omitted) (emphasis added).

[4] *See, e.g.,* Case No. 2018-00086, *Electronic Adjustment of the Pipe Replacement Program Rider of Delta Natural Gas Company, Inc.* (Ky. PSC August 21, 2018), Order at pp. 3-4 ("The Commission is aware of the risk associated with Aldyl-A pipe. As Delta states in its application, Aldyl-A is subject to slow crack growth that leads to eventual rupture of the pipe. Furthermore, Aldyl-A has been the subject of several PHMSA bulletins, the most recent of which is attached hereto as Appendix B. Due to the significant amount of pre-1983 Aldyl-A pipe that exists in the Delta system, the Commission finds that the Aldyl-A pipe should be replaced in a 15-year time frame. As of the date of this Order, the newest of the Aldyl-A pipe on Delta's system is at least 35 years old. At the conclusion of Delta's proposed PRP, the newest of the Aldyl-A pipe will be at least 50 years old. Given that Aldyl-A pipe was installed on Delta's system as early as 1965, and some has already been in service nearly 55 years, the Commission finds that now is an appropriate time to plan for the replacement of Aldyl-A pipe. The Commission expects Delta to continue to prioritize its PRP to replace pipe based on risk, and pipe in high-consequence areas, whether it be bare steel or Aldyl-A pipe."). *See also* Case No. 2022-00341, *Electronic Application of Delta Natural Gas Company, Inc. for its Pipe Replacement Filing* (Ky. PSC Aug. 11, 2023), final Order at 8-9. In that filing, Delta explained that the work expected to be completed during 2023 involved the replacement of approximately 97,000 feet of vintage plastic pipe and approximately 8,000 feet of steel pipe. The vintage pipe appears to consist entirely of pre-1983 Aldyl-A. *Id.*, Direct Testimony of Jonathan Morphew at 3, 6.

justifications for such projects."[5] In that order, the Commission acknowledged that Atmos Energy noted that not all Aldyl-A needs to be replaced immediately and that Atmos Energy would prioritize replacement based on material, location of the pipe in relation to population, and relative risk from third-party damage. Based on that standard, the Commission approved the Cadiz Aldyl-A project. Applying that same standard to this Case would result in approval of the proposed projects.

This application of a different standard to include Aldyl-A projects in Atmos Energy's PRP in this Case is contrary to Kentucky law and requires reconsideration by the Commission. In *Utility Regulatory Commission v. Kentucky Water Service Company, Inc.* ("*Kentucky Water*"), the utility had relied upon the standard set in prior cases regarding the accounting treatment of investment tax credits in its filing of a general rate case. However, the Commission applied a different standard, which the Court of Appeals of Kentucky found was a violation of the utility's due process rights.[6] The facts in this case are analogous to those in *Kentucky Water*. While "minimum safety justifications" is not defined in Case No. 2021-00214, Atmos Energy clearly met that standard in Case No. 2022-00222 with the evidence presented, and it is clearly broader than the "highest risk" standard the Commission is imposing in this Case. Atmos Energy presented the same level and type of evidence in this matter, and its request was arbitrarily denied. Atmos Energy has provided the undisputed safety justifications associated with the Aldyl-A projects proposed in this Case and has met the standard of evidence set by the Commission in Case No. 2021-00214 and affirmed through the Commission's approval of inclusion of the Aldyl-A projects proposed in Case No. 2022-00222. Therefore, Atmos Energy respectfully requests that the Commission reconsider its Order in the instant case and apply the evidentiary standard consistent with Case Nos. 2021-00214 and 2022-

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[5] Case No. 2021-00214, *Electronic Application of Atmos Energy Corporation for an Adjustment of Rates* (Ky. PSC June 15, 2023), Order at 60 (emphasis added).

[6] 642 S.W.2d 591, 592 (Ky. Ct. App. 1982) ("Due process requires, at a minimum, that persons forced to settle their claims of right and duty through the judicial process be given a meaningful opportunity to be heard. It has been said that no hearing in the constitutional sense exists where a party does not know what evidence is considered and is not given an opportunity to test, explain or refute. In *Bowman Transportation v. Arkansas-Best Freight System*, 419 U.S. 281, 287, 95 S. Ct. 438, 442, 42 L. Ed. 2d 447 (1974) the Supreme Court of the United States stated: 'A party is entitled, of course, to know the issues on which decision will turn and to be apprised of the factual material on which the agency relies for decision so that he may rebut it. Indeed, the Due Process Clause forbids any agency to use evidence in a way that forecloses an opportunity to offer a contrary presentation.'") (internal citations omitted).

00222 regarding the inclusion of Aldyl-A projects in the Company's PRP.

As noted in Table TRA-1 in the direct testimony of Company witness T. Ryan Austin, the proposed Aldyl-A projects are:

Table TRA-1 – Proposed Aldyl-A Projects for Fiscal Year 2024

Project Name	Project Description
Aldyl.2736.Nunn Blvd	Replace 2,923' of 1.25" Aldyl A, 15' of 3/4" HDPE, 252 of 1.25" PE, 3,215' of 2" Adly A, 21' of 2" PE with 6427' of 2" HDPE. 62 Services
Aldyl.2736.Glendale Dr	Replace 134' of 1" Aldyl A, 5' of 2" PE, 2,855' of 2" Aldyl A, 158' of 4" Mill Wrap with 3152' of 2" HDPE. 31 Services
Aldyl.2637.Marquees Dr	Replace 3,930' of 1.5" Aldyl A, 1,169' of 2" Aldyl A, 66' of 3" Aldyl A, 3' of 3/4" HDPE and 135 of 2" HDPE with 5,469' of 2" HDPE. 88 Services
Aldyl.2735.Charles Moran Hwy	Replace 6,723' of 2" Aldyl A, 314' of 2" PE, 3' of 3/4" PE with 3,765' of 2" and 4,039' of 4" HDPE. 65 Services

As the Company discussed in Company witness Austin's direct testimony, the Nunn Boulevard and Glendale Drive projects proposed in this proceeding are direct continuations of Aldyl-A projects in Cadiz, Kentucky that the Commission approved in both Case Nos. 2021-00214 and 2022-00222. The Nunn Boulevard project is directly next to the Cunningham Avenue project in the same neighborhood and consists of the same risk factors that the Commission found reasonable and approved in Case No. 2022-00222.[7] The Glendale Drive project is in the same neighborhood as the Lincoln Avenue project and consists of the same risk factors that the Commission found reasonable and approved in Case No. 2022-00222.[8] These similar risk factors are also present as the Aldyl-A projects approved

[7] Case No. 2022-00222, *Electronic Application of Atmos Energy Corporation to Establish PRP Rider Rates for the Twelve Month Period Beginning October 1, 2022* (Ky. PSC May 25, 2023), Order at 3.
[8] Case No. 2022-00222, *Electronic Application of Atmos Energy Corporation to Establish PRP Rider Rates for the Twelve Month Period Beginning October 1, 2022* (Ky. PSC May 25, 2023), Order at 3.

in Cadiz, Kentucky, in Case No. 2021-00214. As mentioned in Case No. 2021-00214, the Cadiz system was installed in the mid-1960s and is entirely Aldyl-A pipe. The system has had a history of leaks caused by the rocky bedding conditions impinging on the Aldyl-A pipe, which has proven to lead to increased cracking. This area also has tracer wire on the pipe that has deteriorated with time which makes it difficult to locate.

The Marquess Drive project proposed in this proceeding is within a high-density and low-income community, and it is also located around Morgan Elementary School. As discussed in Company witness Austin's direct testimony, the existing Aldyl-A pipe in this project is extremely difficult to locate and has led to higher relative risk of damage from excavation and other external forces. The existing Aldyl-A also contains some irregular pipe sizes that are not standard for today, such as the 3" pipe and 1.5" pipe, which would otherwise require special fittings for repairs that would need to be made and the lead time is longer on these materials.

Finally, the Charles Moran Highway Project is located along the primary east-west road going through Horse Cave, Kentucky. The Aldyl-A pipe being replaced in this proposed project was installed in 1967 and is located in a dense area that includes general stores, a gas station, a water district office, and a fire department, leading to this project area as one of the highest relative risks of failure in Atmos Energy's system.

It is important to understand that the Distribution Integrity Management ("DIM") framework established by PHMSA requires that operators "evaluate and rank risk" and then "identify and implement measures to address risks."[9] There are a number of ways to address those risks, and it is left up to the operator as to which method it chooses based on the operator's expertise, available tools, cost considerations, etc. Within each of its jurisdictions, Atmos Energy considers a variety of factors to select which portions of its system on which risks should be mitigated through replacement of facilities, including the risk-ranking based on consequence of failure and likelihood of failure. Consistent with the principles of DIM, the Company has prioritized replacement by examining the

[9] 49 CFR 192.1007.

facts of the Aldyl-A sections in its system. The prioritization of replacement takes into account factors such as age of material, location of the pipe in relation to population, and relative risk from third-party damage. Based on consideration of these risk factors, the Company has identified these specific sections of Aldyl-A for replacement first on its system in conjunction with bare steel. The Company's request on Aldyl-A projects in this filing allows the Company to both target high-risk bare steel in the timeline adopted by the Commission, while simultaneously conducting a measured, targeted, and proactive approach to begin replacing the risk associated with Aldyl-A pipe. Atmos Energy also takes into account the contractors available, geographically equitable distribution of planned investment to benefit customers and communities across the service territory, and limiting potential disruption in the right-of-ways to manageable levels in the communities it serves. The Aldyl-A projects proposed strike a balance along with the bare steel projects in this filing to mitigate risk and provide benefits across our service territory and efficiently use the contractor resources available for pipeline replacement.

The evidence presented in this and prior cases of the risks associated with these facilities is undisputed. Regarding the PHMSA bulletins, PHMSA Advisory Bulletin ADB-07-01 attached in the Application as Exhibit TRA-5 follows up on Advisory Bulletins ADB-99-01, ADB-99-02, and ADB-02-07 and provides updated notification of the susceptibility of older plastic pipes to premature brittle-like cracking. Among older polyethylene pipe materials these included, but are not limited, to Aldyl-A manufactured before 1973. The majority of the Aldyl-A in the proposed projects has been in service more than fifty years. The Nunn Boulevard and Glendale Drive Aldyl-A pipe is from 1966, Marquess Drive Aldyl-A is from 1968, and Charles Moran Highway Aldyl-A is from 1967. This pipe resin is the Alathon 5040 which has a low relative resistance to slow crack growth. The Company's Aldyl-A projects targeted for replacement are all pre-1973 Aldyl-A pipe with the exception of some smaller sections identified in the same area that warrant replacement simultaneously in order to address additional risk factors and also receive the benefit of operational synergies while Atmos Energy is working in that area.

The Company requests modification of the adjustment to the Commission's treatment of Aldyl-A in this Order as the Company believes it is inconsistent with past Commission precedent. The Commission has acknowledged the material is subject to slow crack growth that leads to eventual rupture of the pipe. In accordance with the Commission's past treatment of the projects to address the material, the Company has provided maps, leakage data, and applicable PHMSA advisory bulletins regarding Aldyl-A materials, and specifically pre-1973 Aldyl-A, in multiple cases before the Commission. The purpose of PRP programs is for targeted and accelerated replacement over time of materials such as Aldyl-A, to provide safe and reliable service, and not to simply accelerate recovery as the Commission suggests. As the Commission itself noted in Case No. 2018-00281, "[t]o the extent that the pipeline eligible for recovery poses a safety risk to the utility's customers, service areas, and employees, the Commission has proven itself to be in favor of accelerated replacement."[10] It is both reasonable and prudent for the Company to continue with its measured approach to modestly accelerate the replacement of Aldyl-A pipe. This measured approach consists of the Company proposing approximately $3.5 million in Aldyl-A replacement in Case No. 2022-00222 which was approved, and proposing approximately $3.6 million in the current proceeding to modestly accelerate the replacement of this pipe. Replacement of these pipes allows Atmos Energy to mitigate the risk of incidents that can result in death, injury, or significant property damage. Consistent with the Commission's findings in Case No. 2021-00214 and Case No. 2022-00222, it is in the public interest to include the four Aldyl-A projects proposed in this Case in the Company's PRP for 2024.

2. Reconsideration of the Exclusion of the Company's NOL ADIT

Atmos Energy requests that the Commission reconsider its determination to exclude a portion of NOL ADIT from the Company's rate base in this filing. On page 6 of the Order, the Commission states:

Because Atmos failed to establish that its Kentucky operations were in a net operating

[10] Case No. 2018-00281, *In the Matter of Electronic Application of Atmos Energy Corporation for An Adjustment of Rates and Tariff Modifications* (Ky. PSC May 7, 2019), final Order at 14.

> loss position in the relevant periods, and therefore, that its accelerated tax expensing of PRP investments could not be used to offset tax expense, the Commission finds that Atmos failed to establish that NOL ADIT was or would be generated from its Kentucky operations during the relevant PRP program years.[11]

The Commission provided that Atmos Energy's method of projecting NOL ADIT was unreasonable for a PRP rider because it produced an NOL ADIT estimate that is not reasonably connected to the Company's actual net operating position. The Commission cited *Missouri-American Water Company v. Public Service Commission of Missouri*[12] as an example of a regulatory jurisdiction rejecting a company's NOL ADIT where such amount was computed based on revenues and expenses of a specific surcharge filing and did not consider all of the company's revenues and expenses recognized during the period that included the surcharge.

Additionally, the Commission suggested that Atmos Energy's explanation of how the normalization rules would apply to its ADIT was materially incomplete due to book-to-tax differences associated with repair deductions made for tax but not for book purposes.[13] The Commission states that since these repair deductions are not subject to the tax code's normalization rules the bulk of the ADIT generated in Atmos Energy's 2023 and 2024 fiscal years would not be subject to normalization rules, and therefore, it would not be necessary to include NOL ADIT, if any, offsetting that ADIT liability to avoid a normalization violation.[14]

Based upon the Commission's finding in this Order, Atmos Energy has identified the following three errors with the Commission's application of the Internal Revenue Code normalization rules:

1. The appropriate level for assessing the Company's taxable income or loss position (*i.e.* an allocation of the Company's overall regulated operations or the income/loss derived solely from the Company's Kentucky operations).
2. The relevant time period for determining the Company's taxable income or loss.
3. The determination of taxable losses attributable to accelerated tax depreciation.

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[11] Case No. 2023-00231, *Electronic Application of Atmos Energy Corporation for PRP Rider Rates Beginning October 1, 2023* (Ky. PSC September 29, 2023), Order at 6.
[12] *Missouri-American Water Company v. Public Service Commission of Missouri*, 591 S.W.3d 465 (Mo. App. W.D. 2019).
[13] Case No. 2023-00231, *Electronic Application of Atmos Energy Corporation for PRP Rider Rates Beginning October 1, 2023* (Ky. PSC September 29, 2023), Order at 7.
[14] *Id.* at 8.

Appropriate Level for Assessing Company's Taxable Income or Loss Position

In compliance with the Commission's order in Case No. 2013-00148, the Company filed for a private letter ruling ("PLR") with the Internal Revenue Service ("IRS") requesting the following rulings:

1. The reduction of Atmos Energy's rate base by the balance of its ADIT accounts 282 and 283 unreduced by its NOLC-related deferred tax account (a/c 190) balance would be inconsistent with (and, hence, violative of) the requirements of the Code Section 168(i)(9) and Treasury Regulations Section 1.167(l)-1.
2. For purposes of Ruling 1 above, the use of a balance of Atmos Energy's NOLC-related deferred tax account (a/c 190) that is less than the amount attributable to accelerated depreciation computed on a "last dollars deducted" basis would be inconsistent with (and, hence, violative of) the requirements of Code Section 168(i)(9) and Treasury Regulations Section 1.167(l)-1.

Within the facts presented to the IRS in this ruling request, Atmos Energy stated that its regulated utility operations had produced a federal NOLC and that its computation of jurisdictional rate base included an allocation of the Company's total utility operation ADIT balance to its Kentucky gas distribution operations including a deferred tax asset ("DTA") attributable to the Company's NOLC.

The IRS ruled as follows:

> To reduce Taxpayer's rate base by the full amount of its ADIT account balance unreduced by the balance of its NOLC-related account balance would be inconsistent with the requirements of section 168(i)(9) and section 1.167(l)-1.[15]
>
> The "last dollars deducted" methodology employed by Taxpayer ensures that the portion of the NOLC attributable to accelerated depreciation is correctly taken into account by maximizing the amount of the NOLC attributable to accelerated depreciation. This methodology provides certainty and prevents the possibility of "flow through" of the benefits of accelerated depreciation to ratepayers. Under these specific facts, any method other than the "last dollars deducted" method would not provide the same level of certainty and therefore the use of any other method is inconsistent with the normalization rules.[16]
>
> As noted above, the facts presented to the IRS in the Company's 2015 letter ruling stated that

[15] Case No. 2023-00231, *Electronic Application of Atmos Energy Corporation for PRP Rider Rates Beginning October 1, 2023* (Ky. PSC July 31, 00231), Testimony of Joel J. Multer, Exhibit JJM-1 at 5.
[16] Case No. 2023-00231, *Electronic Application of Atmos Energy Corporation for PRP Rider Rates Beginning October 1, 2023* (Ky. PSC July 31, 00231), Testimony of Joel J. Multer, Exhibit JJM-1 at 6.

its computation of jurisdictional rate base **included an allocation of the Company's total utility operation ADIT balance to its Kentucky operations including DTA attributable to the Company's NOLC** (emphasis added)**.**[17] Under these facts, the IRS ruled in 2015 that to exclude the balance of the Company's allocated NOLC-related account balance would be inconsistent with the normalization rules. Therefore, a determination of the Company's NOLC ADIT in rate proceedings on a basis other than those presented in the Company's ruling presents a direct risk of normalization violation.

Should the Commission choose to assess the normalization rules at the level of the Company's Kentucky operations as opposed to the Company's method of allocating a portion of its overall regulated operations as stated in the facts of its own IRS ruling, Atmos Energy suggests pursuing clarification with the IRS on this issue via the submission to the IRS of a joint letter ruling request, from Atmos Energy and the Commission. This will allow the Commission to make sure the request to the IRS is framed in a way that will directly address the issue at hand.

Relevant Time Period for Determining Company's Taxable Income or Loss

The relevant time periods for assessing the Company's taxable income or loss position in this filing consist of (1) the twelve-month test period ended September 30, 2023, as it relates to ADIT balances within the Company's PRP filing in Case No. 2022-00222 and forming the beginning ADIT balances within this latest PRP filing and (2) the twelve-month test period ended September 30, 2024.

For the twelve-month period ended September 30, 2023, Atmos Energy's overall regulated operations were in a loss position (therefore, increasing NOLC) when considering all revenues and expenses inclusive of those attributable to its PRP filings. Furthermore, Atmos Energy's overall regulated operations were in this loss position as a result of accelerated tax depreciation determined in accordance with the IRS-prescribed method of "last dollars deducted." As a result, Atmos Energy's NOL ADIT balance as presented in Case No. 2022-00222 and as the beginning balance in this filing,

[17] Case No. 2015-00343, *Application of Atmos Energy Corporation for an Adjustment of Rates and Tariff Modifications* (Ky. PSC Nov. 23, 2015), Direct Testimony of Pace McDonald, Exhibit PM-1.

must be included in its determination of rate base to avoid a filing position that is contrary to normalization.

For the twelve-month period ended September 30, 2024, Atmos Energy is looking to its recent experience in assessing its taxable income or loss position for its overall regulated operations. Atmos Energy incurred an overall loss for its regulated operations in its last two fiscal years ended September 30, 2022 and 2023, respectively. Given the potential to incur an overall taxable loss for 2024 as well, the Company's incremental NOL ADIT incurred in the twelve-month test period ended September 30, 2024, should also be included to prevent a result inconsistent with normalization.

The Commission's reference to *Missouri-American Water Company* is distinguishable from the facts in this instance. In *Missouri-American Water Company*, the taxpayer generated overall taxable income (inclusive of revenues and expenses derived from its surcharge filing) for the relevant test period. Here, Atmos Energy's regulated operations are generating a loss during the relevant test period inclusive of PRP activity and such loss is a function of the Company's accelerated tax depreciation deductions based on last dollars deducted methodology. The *Missouri-American Water Company* case involved the treatment of NOL ADIT in a surcharge or rider filing. The IRS ultimately opined on the facts of *Missouri-American Water Company* in letter rulings 202010002 and 202227002 (attached as Exhibit B and Exhibit C, respectively) concluding that whether a taxpayer incurs taxable income or a taxable loss for a surcharge case should be based on the taxpayer's overall revenue and expenses (including those from its surcharge filing) recognized during the test period for which the surcharge filing was made.

Determination of Taxable Loss Attributable to Accelerated Tax Depreciation

The IRS has ruled in Atmos Energy's 2015 PLR ruling, as well as several others, that any method for calculating a taxpayer's loss attributable to accelerated tax depreciation other than the "last dollars deducted" method (also referred to as the "with-and-without" method) is not consistent with the normalization rules. Under this method, a loss is attributable to accelerated depreciation to the extent of the lesser of (1) the accelerated tax depreciation claimed or (2) the amount of the loss.

In effect, all deductions other than accelerated depreciation are offset against available taxable income prior to considering accelerated depreciation.

The Commission in this Order states that since repair deductions are not subject to the tax code's normalization rules the bulk of the ADIT generated in Atmos Energy's 2023 and 2024 fiscal years would not be subject to normalization rules, and therefore, it would not be necessary to include NOL ADIT, if any, offsetting that ADIT liability to avoid a normalization violation.[18] The Commission is correct in its statement that repair deductions are not subject to the normalization rules as repair deductions do not fall within the tax code section pertaining to accelerated depreciation. However, the normalization rules require the determination of a taxpayer's loss to be performed on the basis of last dollars deduction or with-and-without accelerated tax depreciation.[19] Under this methodology, the Company's overall loss for the twelve-month period ended September 30, 2023, is a function of accelerated tax depreciation and, therefore, subject to the tax code's normalization rules. The issue of repair deductions is irrelevant to the determination of the applicability of the normalization rule in this instance.

For these reasons, the Company respectfully requests the Commission reconsider its finding to remove a portion of NOL ADIT from rate base used to determine PRP revenue in this case.

3. Clarification on the Implementation of the $30 Million Capital Spending Cap for PRP Investment

On pages 15-16 of the Order, the Commission states:

> The Commission finds that the annual cap of $28 million on PRP investment imposed in Case No. 2017-00349 remains appropriate and reasonable to complete replacement of high-risk bare steel pipe by the 2027 deadline while protecting Atmos's ratepayers from unreasonable rider rates. While the Orders in Case Nos. 2021-00214 and 2022-00222 did not explicitly discuss the $28 million cap on Atmos's PRP, neither stated the cap was no longer applicable. Further, for the reasons discussed in previous orders, the Commission finds that Atmos's PRP investment should continue to be

[18] Case No. 2023-00231, *Electronic Application of Atmos Energy Corporation for PRP Rider Rates Beginning October 1, 2023* (Ky. PSC September 29, 2023), Order at 8.

[19] *See, e.g.,* Case No. 2023-00231, *Electronic Application of Atmos Energy Corporation for PRP Rider Rates Beginning October 1, 2023* (Ky. PSC July 31, 00231), Testimony of Joel J. Multer, Exhibit JJM-1 at 6; *see also,* Case No. 2015-00343, *Application of Atmos Energy Corporation for an Adjustment of Rates and Tariff Modifications* (Ky. PSC Nov. 23, 2015), Direct Testimony of Pace McDonald, Exhibit PM-1.

subject to a cap, but that it should be raised to $30 million.[20]

As the Order states, the Commission has raised the cap on PRP investment to $30 million. Following the Commission's removal of Aldyl-A projects in this PRP filing, the total PRP investment is slightly less than the $28 million as imposed originally in Case No. 2017-00349. The Company respectfully requests that the $30 million PRP investment amount be considered and applied in this Order, as the Order is unclear whether the raised cap is now applicable to this filing or only to future PRP filings. The additional $2 million PRP investment applied to this filing will aid both the Company and Commission's goal to remove high-risk bare steel by 2027. The Company respectfully submits the following additional bare steel projects in Exhibit A of this Petition for inclusion and approval in this year's filing which will help accomplish the Company and Commission's goal to remove high-risk bare steel while remaining in compliance with the newly-imposed $30 million PRP investment cap. These bare steel projects chosen by the Company are in the vicinity of existing bare steel projects for the upcoming year and allow the Company to efficiently complete these projects in a more cost-effective manner using contractors already mobilized.

4. **Reconsideration for the Company to "True-Up" and Collect Annual PRP Rider Revenue associated with the Tariff Reference Period**

The Company's fourth request is for reconsideration on the Commission's denial for the Company to "true-up" and collect PRP revenue associated with the period between October 1, 2021, and September 30, 2022, for its PRP filing in this Case. As background, in Case No. 2021-00304 the Commission entered its order suspending the effective date of the Company's proposed PRP rates to await the outcome of the Company's outstanding general rate case at the time, Case No. 2021-00214, regarding the appropriate return on equity and the proposed inclusion of Aldyl-A plastic pipe replacements in the PRP. The Company filed a motion for rehearing on June 7, 2022, in Case No. 2021-00214 regarding the treatment and method of collection of full PRP revenue, as the

[20] Case No. 2023-00231, *Electronic Application of Atmos Energy Corporation for PRP Rider Rates Beginning October 1, 2023* (Ky. PSC September 29, 2023), Order at 15-16.

Commission's final order in that case did not give consideration to the delay in implementation of PRP rates between October 1, 2021, and May 19, 2022. In this Order the Commission stated that it "finds that Atmos's tariff did not contemplate a true-up under the circumstances and that allowing such a true-up could result in costs being recovered in both base and PRP rates in violation of KRS 278.509."[21] The Company's PRP tariff states that "the filing will reflect…a balancing adjustment to reconcile collections with actual investment for the program year from two years prior." The Commission's Order is reading into Atmos Energy's tariff new requirements that do not exist. The Company has provided the true-up calculations in this Case as required by the tariff. In this filing, the Company has calculated the true-up in accordance with past Commission precedent as discussed below and provided those calculations in Exhibit B-2.

The Company agrees that a true-up of any time period beyond May 19, 2022, when base rates were updated to include the outcome in Case No. 2021-00214, would not be appropriate. The period between October 1, 2021 and May 19, 2022, when the Company invested in the underlying projects of the PRP filing and recovered no related revenue, is the issue being requested for reconsideration. These similar facts occurred in the true-up for the Company's PRP filings in both Case Nos. 2015-00272 and 2017-00308 regarding the roll-in of base rates from general rate cases 2013-00148 and 2015-00343, respectively. In both these cases the true-up period calculations were prorated based on the number of days in which no related revenue was recovered,[22] and in both cases the true-up calculations were approved by the Commission.[23] The Company has followed the same proration methodology in calculating the true up in this filing as shown on Exhibit B-2 of its Application and

[21] Case No. 2023-00231, *Electronic Application of Atmos Energy Corporation for PRP Rider Rates Beginning October 1, 2023* (Ky. PSC September 29, 2023), Order at 10.

[22] *See* Case No. 2015-00272, *Application of Atmos Energy Corporation to Establish PRP Rider Rates for the Twelve Month Period Beginning October 1, 2015* (Ky. PSC July 31, 2015), Exhibit B-2 (Prorated recovery amount for period of October 2013-January 2014 for 116 days out of 365-day period to address base rates going into effect from Case No. 2013-00148); Case No. 2017-00308, *Electronic Application of Atmos Energy Corporation for PRP Rider Rates* (Ky. PSC July 28, 2017) Exhibit B-2, (Prorated recovery amount for October 2015-August 2016 period for 319 days out of 365-day period to address base rates going to effect from Case No. 2015-00343).

[23] Case No. 2015-00272, *Application of Atmos Energy Corporation to Establish PRP Rider Rates for the Twelve Month Period Beginning October 1, 2015* (Ky. PSC September 23, 2015) Order at 3; Case No. 2017-00308, *Electronic Application of Atmos Energy Corporation for PRP Rider Rates* (Ky. PSC Oct. 27, 2017) Order at 3.

its related workpapers to where the Company has prorated the approved recovery amount for 230 days out of the 365-day period. This true-up is not designed to be a permanent part of rates and therefore run the risk of double recovering this investment but instead is meant to be a one-time recovery of revenue shortfall for the time period before base rates were updated with this investment and the Company respectfully requests reconsideration for the inclusion of the true-up as filed in the Company's filing and in accordance with past Commission precedent.

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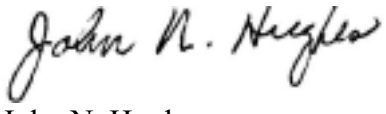

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Atmos Energy Corporation
Case No. 2023-00231
Motion for Rehearing - Exhibit A
Bare Steel Projects

		No. of	Installation			Cost of Removal		
Projects	Project Description	services	Main	Services	Meters	Main	Services	Meters
PRP.2634.Buckner St	Replace 1,248' of 2" Painted, 30' of 2" Epoxy, 103' of4" unknown coating, 1,218' of 2" Mill Wrap, 40' of 4" Fusion Bond Epoxy, 395' of 4" Epoxy, 461' of 2" Unknown coating, 371' of 4" Mill Wrap, 904' of4" Bare, 1,182' of 4" Painted, with 2,958' of 2" and 2,994' of 4" HDPE. 92 Services	92	542,585			$28,557		
	Contractor			312,018			16,422	
	Material			57,960	14,078			
	Overhead			83,689	3,184		3,715	
PRP.2634.Noel Ave	Replace 492' of 4" Bare Stl., 505' of 2" Painted Stl., 283' of 3" Bare Steel, 55' of 1.25" Epoxy , 6' of 2" PE, 78' of 4" Epoxy, 2,169' of 2" Bare Stl., 419' of Fusion Bond Epoxy,209' of Painted, 244' of 2" Unknown coating, 12' of 3" Epoxy, 15' of 4" PE, 5' of 3/4" PE, 475' of 2" Mill Wrap, 181' of 2" Epoxy, with 3,061' of 2" ,and 2,088' of 4" HDPE. 53 Services	53	462,802			$24,358		
	Contractor			179,750			9,461	
	Material			33,390	8,110			
	Overhead			48,212	1,834		2,140	
	Total Additional Bare Steel Projects		1,005,387	715,019	27,207	52,915	31,737	-

Internal Revenue Service

Department of the Treasury
Washington, DC 20224

Number: **202010002**
Release Date: 3/6/2020

Index Number: 168.24-01

Third Party Communication: None
Date of Communication: Not Applicable

Person To Contact:
, ID No.

Telephone Number:

Refer Reply To:
CC:PSI:B06
PLR-113227-19
Date: December 3, 2019

In Re:

LEGEND:

Taxpayer	=
Parent	=
State A	=
State B	=
Commission	=
Date 1	=
Date 2	=
Date 3	=
Date 4	=
Date 5	=
Date 6	=
Date 7	=
Date 8	=
Date 9	=

Date 10 =

Date 11 =

Date 12 =

Date 13 =

Date 14 =

Date 15 =

Date 16 =

Month 1 =

Month 2 =

Month 3 =

Month 4 =

Month 5 =

Month 6 =

Year 1 =

Year 2 =

Year 3 =

Year 4 =

Year 5 =

a =

b =

c =

d =

e =

f =

g =
h =

i =

j =

k =

l =

Dear :

This letter responds to a request for a private letter ruling dated June 5, 2019, and submitted on behalf of Taxpayer for rulings under § 168(i)(9) of the Internal Revenue Code and § 1.167(l)-1 of the Income Tax Regulations (together, the "Normalization Rules") regarding the scope of the deferred tax normalization requirements and the appropriate methodology for the reduction of the accumulated deferred income tax ("ADIT") balance that decreases rate base computation when a net operating loss carryforward ("NOLC") exists. The relevant facts as represented in your submission are set forth below.

FACTS

Taxpayer files a consolidated federal income tax return on a calendar year basis with its affiliates, including its Parent. Taxpayer uses the accrual method of accounting.

Parent is incorporated in State A, and Taxpayer is incorporated in State B. Parent is a water and wastewater utility company. Taxpayer is the affiliate that operates in State B. Prices charged by Taxpayer are set by Commission. Commission sets rates that Taxpayer may charge for the furnishing or sale of water or sewage disposal services through a combination of periodic general rate case proceedings (resulting in what are commonly referred to as "base rates") and infrastructure surcharge proceedings (resulting in surcharges that are added to base rates.)

The most recent two base rate changes resulting from general rate case authorizations by Commission affecting water and wastewater revenue requirements were effective in Month 1 Year 1 and Month 2 Year 2. The most recent three rate changes resulting from infrastructure surcharge authorizations by Commission were effective in Month 3 Year 3, Month 4 Year 4 and Month 4 Year 2. Taxpayer questions whether the rates set pursuant to the most recent infrastructure surcharge proceeding comply with the deferred tax normalization requirements.

Infrastructure surcharges are regulatory mechanisms to permit recovery of capital investments and results in adjustments to rates charged outside of a general rate case for specified costs and investments. Under State B statute and Commission rulemaking, eligible water corporations may petition Commission and utilize a Infrastructure System Replacement Surcharge ("Surcharge") to recover the costs of eligible water utility main replacements and relocations.

For both general rate case proceedings and Surcharge proceedings, Taxpayer computes a revenue requirement subject to Commission approval based on recovery of a debt- and equity-based return on investment in rate base, including the cost of plant assets less accumulated book depreciation and ADIT, and a recovery of operating expenses, including depreciation expense, property tax expense, and income tax expense. For Surcharge proceedings, rate base is determined based on incremental plant expenditures incurred during a historical measurement period (not necessarily 12 months) ending shortly before rates become effective, less accumulated book depreciation and ADIT computed as of a date subsequent to the date at which gross plant is computed and closer to (but preceding) the date that rates become effective. For Surcharge proceedings, operating expenses include 12 months of annualized depreciation expense on the incremental investment in the Surcharge proceeding and any property taxes that will be paid within 12 months of filing the Surcharge application.

The deferred tax normalization matters in this request arose during the Surcharge proceeding initiated by Taxpayer in Month 5 Year 2 and resulting in a Commission order on Date 1 (the "Surcharge Case"). The Surcharge resulting from the Surcharge Case became effective on Date 2. Some of the normalization matters addressed in this ruling request related to deductions and ADIT resulting from the consent agreement that Parent received from the Service on Date 3, on behalf of itself and various affiliates, including Taxpayer, with respect to changes in tax method of accounting for costs to repair and maintain tangible property and dispositions of certain tangible depreciable property ("Consent Agreement").

State B statutes and Commission B rules provide eligible water corporations with the ability to recover certain infrastructure system replacement costs outside of a formal rate case filing via a Surcharge. A petition must be filed with the Commission for review and approval before an adjustment can be made to a water corporation's rates and charges to provide for the recovery of the costs associated with eligible infrastructure system replacements. A State B statute authorizes Commission to enter an order authorizing the water corporation to impose a Surcharge that is sufficient to recover appropriate pretax revenues. The State B statute defines the revenue requirement set in a Surcharge proceeding and provides that "appropriate pretax revenues" are the revenues necessary to produce net operating income equal to the water corporation's weighted cost of capital multiplied by the net original cost of eligible infrastructure system replacements, including recognition of accumulated deferred income taxes and accumulated depreciation associated with eligible infrastructure system

replacements. . .” among other items. Taxpayer represents that Commission and the State B courts have interpreted this statute in a strict manner thereby limiting the costs eligible for recovery or to earn a return in a Surcharge proceeding and causing costs not eligible for ratemaking consideration in a Surcharge proceeding to only be eligible for recovery or return in the next base rate proceeding.

Taxpayer, per its petition filed with Commission on Date 4, sought to establish a Surcharge rate to provide for the recovery of actual costs for eligible infrastructure system replacements and relocations from Date 5 through Date 6, and estimated investment accounts for Date 7 through Date 8. During the course of the Surcharge case, Taxpayer provided Commission with actual expenditures for Month 5 and Month 6. The proposed Surcharge rate schedule reflected the pre-tax Surcharge revenues necessary to produce net operating income equal to Taxpayer’s weighted cost of capital multiplied by the original cost of the requested infrastructure replacements that are eligible for the Surcharge, reduced by net ADIT and accumulated depreciation associated with eligible infrastructure system replacements through Date 9. Taxpayer also sought to recover all state, federal and local income or excise taxes applicable to such Surcharge income and to recover all other Surcharge costs including annualized depreciation expense and property taxes due within 12 months.

The specific test period and service period information pertaining to the Surcharge Case is:

- Rates became effective Date 2
- Actual gross plant was based on additions of certain property placed in service from Date 5 through Date 8
- Accumulated depreciation on such assets was estimated through Date 9
- Estimated ADIT related to depreciation book/tax differences associated with such expenditures to the extent also capitalized for tax purposes was computed through Date 9
- Estimated ADIT related to repair book/tax differences associated with such expenditures to the extent not capitalized for tax purposes was computed through Date 9
- Recoverable operating expenses were estimated for the period beginning Date 10 and ending Date 9

In a Surcharge proceeding, replacement mains and associated valves and hydrants comprise the plant assets included in rate base and result in the accumulated depreciation reducing rate base and the recoverable depreciation expense. The expenditures for replacement mains and associated valves addressed in a Surcharge proceeding are capitalizable for regulatory accounting purposes, but may result in a repair deduction for tax purposes or depreciable plant for tax purposes. The ADIT balance reducing rate base in a Surcharge proceeding is caused by depreciation-related and repair-related book/tax differences.

The key issues in the Surcharge case and, thus, in this ruling request, pertain to whether the tax effect of an NOLC must, pursuant to the normalization requirements, decrease the ADIT reduction to rate base related to the expenditures in the Surcharge case and, if so, the methodology to determine the amount of the NOLC adjustment subject to the normalization requirements. The return on rate base is based on the pre-tax rate of return authorized in the most recent rate order resulting from a general rate proceeding.

In the course of the Surcharge Case, Taxpayer and other participants in the proceeding analyzed the expenditures for which Taxpayer sought recovery via the Surcharge and debated the proper regulatory treatment of Taxpayer's NOLC and tax loss incurred through the rate base determination date of the Surcharge case with respect to the costs incurred that are recoverable in the Surcharge case. The revenue requirement approved in Commission's order issued on Date 1 was lower than the revenue requirement sought by Taxpayer and is entirely attributable to differing ADIT calculations with respect to the NOLC and the resulting effects on rate base and allowed return. The approved revenue requirement in the Surcharge case was based on a rate base computation that reflects the gross ADIT liabilities associated with depreciation-related and repair-related book/tax differences, but did not reflect an ADIT asset for any portion of Taxpayer's NOLC as of the date that rate base was determined (Date 9) , including the tax loss resulting from the infrastructure expenditures addressed in the Surcharge Case.

On a consolidated basis, Parent incurred tax losses in various years from Year 5 to Year 1 and, as of Date 11, had an NOLC of approximately $a. On a separate company basis, Taxpayer incurred tax losses in various tax years from Year 5 – Year 1 and, as of Date 11, had a separate company NOLC of approximately $b. For Year 2, Parent (on a consolidated basis) and Taxpayer (on a separate company basis) estimate that taxable income was earned and, thus, NOLC was utilized.

The revenue requirement related to the Surcharge Case is approximately $c (pursuant to the rate order). Taxpayer asserts that the revenue requirement should have been computed to be $d. The difference in the revenue requirement computations relates entirely to the exclusion of Taxpayer's NOLC from rate base. As of the date of the rate base determination, none of the Surcharge revenues had been billed to customers and, thus, as of such date, a taxable loss of approximately $e had been incurred with respect to the plant-related expenditures with rates set by the Surcharge Case.

During the loss years resulting in Taxpayer's NOLC estimated as of the end of the test period for the Surcharge Case, separate company deductible depreciation-related book/tax differences were approximately $f and separate company deductible repair-related book/tax differences were approximately $g (plus the § 481(a) adjustment with respect to the tax accounting method changes subject to the Consent agreement deducted in Year 5 of approximately $h.

The NOLC reflected in ratemaking for the base rate case proceeding with rates effective in Month 2 Year 2 was based on the estimated NOLC as of the end of Year 4 of $i, including an estimated Year 4 tax loss of $j. The actual Year 4 tax loss reported on the Year 4 tax return was $k. The excess of the actual Year 4 tax loss over the estimated Year 4 tax loss of $l has yet to be reflected in ratemaking.

On Date 12, Taxpayer filed an Application for Rehearing and Motion to Defer Ruling, asking the Commission for the time to seek a private letter ruling form of guidance from the Service to address any uncertainties regarding the application of the deferred tax normalization requirements to the rate base treatment of the NOLC-related ADIT asset in computing the Surcharge case revenue requirement. On Date 13, the Commission denied Taxpayer's request for rehearing. Taxpayer filed a notice of appeal by Date 14, that initiated an appeal of the order in the Surcharge case to the State B Court of Appeals. Taxpayer anticipates receiving a private letter ruling from the Service prior to the State B Court of Appeals issuing a final opinion in Taxpayer's appeal of the Commission denial of Taxpayer's Motion for Rehearing. If the Service rules that the Commission's decision in Taxpayer's Surcharge case ordered a method of regulatory accounting that is inconsistent with the deferred tax normalization requirements, Taxpayer believes that the Commission and Taxpayer would be procedurally able to correct the revenue requirement in a manner that compensates Taxpayer for any foregone revenue requirement relative to ADIT and rate base computations that comply with the normalization requirements.

Because Taxpayer is concerned that the order issued by Commission as part of the Surcharge case on Date 1, and the prices that became effective on Date 2, are inconsistent with the deferred tax normalization requirements, Taxpayer submitted a letter to the Service on Date 14 intended to provide the notification pursuant to § 1.167(l)-1(h)(5) of the Regulations.

As noted, on Date 3, Taxpayer's parent corporation received the Consent Agreement from the Internal Revenue Service granting certain of its subsidiaries, including Taxpayer, permission to change their (1) method of accounting for costs to repair and maintain tangible property from capitalizing and depreciating these costs to deducting these costs under § 162 of the Internal Revenue Code, and (2) unit of property for determining dispositions of depreciable network assets from using a method other than the functional interdependence test to using the functional interdependence test to determine the units of property. These changes in methods of accounting were effective for the taxable year beginning Date 15, and ended Date 16 (the "year of change").

These changes in methods of accounting resulted in an overall net negative § 481(a) adjustment for Taxpayer as stated in the Consent Agreement. This overall net negative § 481(a) adjustment consists of a net negative § 481(a) adjustment for the

repair and maintenance change in method of accounting and a net positive § 481(a) adjustment for the disposition change in method of accounting.

The Service's consent to the above changes in methods of accounting is subject to several terms and conditions stated in the Consent Agreement. Condition nine of the Consent Agreement requires that if any item of property subject to the taxpayer's Form 3115 is public utility property within the meaning of § 168(i)(10) or former § 167(l)(3)(A): (A) a normalization method of accounting (within the meaning of § 168(i)(9), former § 168(e)(3)(B), or former § 167(l)(3)(G), as applicable) must be used for the public utility property subject to the Form 3115; (B) as of the beginning of the year of change, the taxpayer must adjust its deferred tax reserve account or similar reserve account in the taxpayer's regulatory books of account by the amount of the deferral of federal income tax liability associated with the § 481(a) adjustment applicable to the public utility property subject to the Form 3115; and (C) within 30 calendar days of filing the federal income tax return for the year of change, the taxpayer must provide a copy of the Form 3115 (and any additional information submitted to the Service in connection with such Form 3115) to any regulatory body having jurisdiction over the public utility property subject to the Form 3115. See page 6 of the Consent Agreement.

Based on Taxpayer's interpretation of this condition in the Consent Agreement, Taxpayer has applied the normalization requirements to its repair-related and disposition-related deferred tax computations in rate proceedings since the year of change.

Prior to the year of change (Year 5), Taxpayer depreciated public utility property that was in service as of the end of the taxable year immediately preceding the year of change using different book and tax methods and lives. As a result, an amount of ADIT subject to the normalization requirements was recorded prior to the above changes in methods of accounting for repairs and dispositions (depreciation-related ADIT).

Differing assertions were made as part of the Surcharge Case. Ultimately the Commission in its final order determined that because there was not an NOL expected to be generated in Year 4, no portion of the NOLC deferred tax asset can be associated with the Surcharge property.

RULINGS REQUESTED

1) The property otherwise depreciable under § 168(a) and for which cost recovery and return on investment initially occur as part of the Surcharge Case, rather than as part of base rates set in less frequent general rate case proceedings, constitutes public utility property within the meaning of § 168(i)(10).

2) The ADIT amounts used in computing the revenue requirement set in the Surcharge Case with respect to public utility property within the meaning of § 168(i)(10)

must comply with the normalization method of accounting within the meaning of § 168(i)(9).

3) For any public utility property within the meaning of § 168(i)(10) as of the end of the tax year immediately preceding the year of change for the changes in tax method of accounting subject to Taxpayer's Consent Agreement, the depreciation-related ADIT prior to the change in tax method of accounting for repairs and dispositions remains subject to the normalization method of accounting within the meaning of § 168(i)(9) after implementation of the new tax method of accounting.

4) For any public utility property within the meaning of § 168(i)(10) and subject to Taxpayer's Consent Agreement, the ADIT resulting from the repair-related § 481(a) adjustment is not subject to the normalization method of accounting within the meaning of § 168(i)(9).

5) The ADIT resulting from expenditures (1) related to an item of property includible in rate base and recoverable as regulatory depreciation expense in the determination of the revenue requirement set in the Surcharge Case and (2) deducted as repairs under § 162 to public utility property within the meaning of § 168(i)(10), or a predecessor provision of the normalization requirements, pursuant to the tax method of accounting for repairs permitted in Taxpayer's Consent Agreement, is not subject to the normalization method of accounting within the meaning of § 168(i)(9) or, as applicable, a predecessor statutory provision.

6) The ADIT resulting from book/tax differences related to depreciable method and life for public utility property that exists at the date of a retirement of the property for regulatory accounting purposes in a transaction involving a replacement or relocation that is not treated as a disposition under Taxpayer's tax method of accounting for dispositions permitted in Taxpayer's Consent Agreement remains subject to the normalization method of accounting within the meaning of § 168(i)(9) after the book-only retirement.

7) For any public utility property within the meaning of § 168(i)(10) for which a disposition had been recognized for tax purposes in a tax year prior to the tax year of change for the changes in tax method of accounting subject to Taxpayer's Consent Agreement and for which the taxable gain or loss upon such disposition was reversed as part of the disposition-related § 481(a) adjustment, the ADIT related to the restored tax basis of such public utility property is subject to the normalization method of accounting within the meaning of § 168(i)(9), despite the book-only retirement.

8) If the Service rules as Taxpayer has requested with respect to issue # 5 and holds that ADIT resulting from repair-related book/tax differences is not subject to the normalization requirements, Taxpayer requests that the Service also rule: In order to comply with the normalization method of accounting within the meaning of § 168(i)(9), the amount of depreciation-related ADIT reducing rate base used to determine the

revenue requirement set in the Surcharge Case is limited to the amount of depreciation-related deferred tax expense recovered in rates as of the Surcharge Case rate base determination date.

9) If the Service rules as Taxpayer has requested with respect to issue # 5 and holds that ADIT resulting from repair-related book/tax differences is not subject to the normalization requirements, Taxpayer requests that the Service also rule: Under the circumstances described above, in order to comply with the normalization method of accounting within the meaning of § 168(i)(9), the amount of depreciation-related ADIT reducing rate base used to determine the revenue requirement set in the Surcharge Case must be decreased to reflect a portion of the NOL for the test period for the Surcharge Case which would not have arisen had Taxpayer not reported depreciation-related book/tax differences during the text period for the Surcharge Case and such decrease in depreciation-related ADIT must be an amount that is no less than the amount computed using the With-and-Without Method.

10) If the Service (a) rules as Taxpayer has requested with respect to issue # 5 and holds that ADIT resulting from repair-related book/tax differences is not subject to the normalization requirements, but (b) does not grant ruling # 9 in accordance with Taxpayer's analysis, Taxpayer requests that the Service instead rule: Under the circumstances described above, in order to comply with the normalization method of accounting within the meaning of § 168(i)(9), the amount of depreciation-related ADIT reducing rate base used to determine the revenue requirement set in the Surcharge Case must be decreased to reflect a portion of the NOLC which would not have arisen (or an increase in such NOLC which would not have arisen) had Taxpayer not reported depreciation-related book/tax differences during the test period for the Surcharge Case and such decrease in depreciation-related ADIT must be an amount that is no less than the amount computed using the With-and-Without Method but only to the extent that the NOLC has not reduced depreciation-related ADIT in rate base computation in another rate proceeding with prices still in effect.

11) If the Service rules as Taxpayer has requested with respect to issue # 5 and holds that ADIT resulting from repair-related book/tax differences is not subject to the normalization requirements, Taxpayer requests that the Service also rule: Under the circumstances described above, in order to comply with the normalization method of accounting within the meaning of § 168(i)(9), it is not necessary to decrease ADIT or otherwise increase rate base for the Surcharge Case by the portion of the NOLC which would not have arisen (or an increase in such NOLC which would not have arisen) had Taxpayer not reported depreciation-related book/tax differences in prior periods or during the test period for the Surcharge Case with respect to public utility property with rates not set by the Surcharge Case.

12) If the Service does not rule as Taxpayer has requested with respect to issue # 5 and holds that ADIT resulting from repair-related book/tax differences is subject to the normalization requirements, Taxpayer requests that the Service also rule: Under

the circumstances described above, in order to comply with the normalization method of accounting within the meaning of § 168(i)(9), the amount of ADIT reducing rate base used to determine the revenue requirement set in the Surcharge Case must be decreased to reflect the portion of the Surcharge Case test period NOL which would not have arisen had Taxpayer not reported the depreciation-related book/tax difference or repair-related book/tax difference permitted in Taxpayer's Consent Agreement with respect to expenditures with ratemaking determined pursuant to the Surcharge Case, by an amount that is no less than the amount computed using the With-and-Without Method. If, instead, the Service rules as Taxpayer has requested with respect to issue # 5, ruling request # 12 would be moot.

LAW AND ANALYSIS

Section 168(f)(2) provides that the depreciation deduction determined under § 168 shall not apply to any public utility property (within the meaning of § 168(i)(10)) if the taxpayer does not use a normalization method of accounting.

Section 168(i)(10) defines, in part, public utility property as property used predominantly in the trade or business of the furnishing or sale of electrical energy if the rates for such furnishing or sale, as the case may be, have been established or approved by a State or political subdivision thereof.

Prior to the Revenue Reconciliation Act of 1990, the definition of public utility property was contained in § 167(l)(3)(A) and § 168(i)(10), which defined public utility property by means of a cross reference to § 167(l)(3)(A). The definition of public utility property is unchanged. Section 1.167(l)-1(b) provides that under § 167(l)(3)(A), property is public utility property during any period in which it is used predominantly in a § 167(l) public utility activity. The term "section 167(l) public utility activity" means, in part, the trade or business of the furnishing or sale of electrical energy if the rates for such furnishing or sale, as the case may be, are regulated, i.e., have been established or approved by a regulatory body described in § 167(l)(3)(A). The term "regulatory body described in § 167(l)(3)(A)" means a State (including the District of Columbia) or political subdivision thereof, any agency or instrumentality of the United States or a public service or public utility commission or other body of any State or political subdivision thereof similar to such a commission. The term "established or approved" includes the filing of a schedule of rates with a regulatory body which has the power to approve such rates, though such body has taken no action on the filed schedule or generally leaves undisturbed rates filed by the taxpayer.

The definitions of public utility property contained in § 168(i)(10) and former § 46(f)(5) are essentially identical. Section 1.167(l)-1(b) restates the statutory definition providing that property will be considered public utility property if it is used predominantly in a public utility activity and the rates are regulated. Section 1.167(l)-1(b)(1) provides that rates are regulated for such purposes if they are established or approved by a regulatory body. The terms established or approved are further defined

to include the filing of a schedule of rates with the regulatory body that has the power to approve such rates, even if the regulatory body has taken no action on the filed schedule or generally leaves undisturbed rates filed.

The regulations under former § 46, specifically § 1.46-3(g)(2), expand the definition of regulated rates. The expanded definition embodies the notion of rates established or approved on a rate of return basis. This notion is not specifically provided for in the regulations under former § 167. Nevertheless, there is an expressed reference to rate of return in § 1.167(l)-1(h)(6)(i). The operative rules for normalizing timing differences relating to use of different methods and periods of depreciation are only logical in the context of rate of return regulation. The normalization method, which must be used for public utility property to be eligible for the depreciation allowance available under § 168, is defined in terms of the method the taxpayer uses in computing its tax expense for purposes of establishing its cost of service for ratemaking purposes and reflecting operating results in its regulated books of account. Thus, for purposes of applying the normalization rules, the definition of public utility property is the same for purposes of the investment tax credit and depreciation.

Section 168(f)(2) of the Code provides that the depreciation deduction determined under § 168 shall not apply to any public utility property (within the meaning of § 168(i)(10)) if the taxpayer does not use a normalization method of accounting.

In order to use a normalization method of accounting, § 168(i)(9)(A)(i) requires the taxpayer, in computing its tax expense for establishing its cost of service for ratemaking purposes and reflecting operating results in its regulated books of account, to use a method of depreciation with respect to public utility property that is the same as, and a depreciation period for such property that is not shorter than, the method and period used to compute its depreciation expense for such purposes. Under § 168(i)(9)(A)(ii), if the amount allowable as a deduction under § 168 differs from the amount that would be allowable as a deduction under § 167 using the method, period, first and last year convention, and salvage value used to compute regulated tax expense under § 168(i)(9)(A)(i), the taxpayer must make adjustments to a reserve to reflect the deferral of taxes resulting from such difference.

Section 168(i)(9)(B)(i) provides that one way the requirements of § 168(i)(9)(A) will not be satisfied is if the taxpayer, for ratemaking purposes, uses a procedure or adjustment which is inconsistent with such requirements. Under § 168(i)(9)(B)(ii), such inconsistent procedures and adjustments include the use of an estimate or projection of the taxpayer's tax expense, depreciation expense, or reserve for deferred taxes under § 168(i)(9)(A)(ii), unless such estimate or projection is also used, for ratemaking purposes, with respect to all three of these items and with respect to the rate base (referred to as the “Consistency Rule”).

Former § 167(l) generally provided that public utilities were entitled to use accelerated methods for depreciation if they used a “normalization method of

accounting." A normalization method of accounting was defined in former § 167(l)(3)(G) in a manner consistent with that found in § 168(i)(9)(A). Section 1.167(l)-1(a)(1) provides that the normalization requirements for public utility property pertain only to the deferral of federal income tax liability resulting from the use of an accelerated method of depreciation for computing the allowance for depreciation under § 167 and the use of straight-line depreciation for computing tax expense and depreciation expense for purposes of establishing cost of services and for reflecting operating results in regulated books of account. These regulations do not pertain to other book-tax timing differences with respect to state income taxes, F.I.C.A. taxes, construction costs, or any other taxes and items.

Section 1.167(l)-1(h)(1)(i) provides that the reserve established for public utility property should reflect the total amount of the deferral of federal income tax liability resulting from the taxpayer's use of different depreciation methods for tax and ratemaking purposes.

Section 1.167(l)-1(h)(1)(iii) provides that the amount of federal income tax liability deferred as a result of the use of different depreciation methods for tax and ratemaking purposes is the excess (computed without regard to credits) of the amount the tax liability would have been had the depreciation method for ratemaking purposes been used over the amount of the actual tax liability. This amount shall be taken into account for the taxable year in which the different methods of depreciation are used. If, however, in respect of any taxable year the use of a method of depreciation other than a subsection (1) method for purposes of determining the taxpayer's reasonable allowance under § 167(a) results in a net operating loss carryover to a year succeeding such taxable year which would not have arisen (or an increase in such carryover which would not have arisen) had the taxpayer determined his reasonable allowance under § 167(a) using a subsection (1) method, then the amount and time of the deferral of tax liability shall be taken into account in such appropriate time and manner as is satisfactory to the district director.

Section 1.167(l)-1(h)(2)(i) provides that the taxpayer must credit this amount of deferred taxes to a reserve for deferred taxes, a depreciation reserve, or other reserve account. This regulation further provides that, with respect to any account, the aggregate amount allocable to deferred tax under § 167(1) shall not be reduced except to reflect the amount for any taxable year by which Federal income taxes are greater by reason of the prior use of different methods of depreciation. That section also notes that the aggregate amount allocable to deferred taxes may be reduced to reflect the amount for any taxable year by which federal income taxes are greater by reason of the prior use of different methods of depreciation under § 1.167(l)-1(h)(1)(i) or to reflect asset retirements or the expiration of the period for depreciation used for determining the allowance for depreciation under § 167(a).

Section 1.167(l)-1(h)(6)(i) provides that, notwithstanding the provisions of subparagraph (1) of that paragraph, a taxpayer does not use a normalization method of

regulated accounting if, for ratemaking purposes, the amount of the reserve for deferred taxes under § 167(l) which is excluded from the base to which the taxpayer's rate of return is applied, or which is treated as no-cost capital in those rate cases in which the rate of return is based upon the cost of capital, exceeds the amount of such reserve for deferred taxes for the period used in determining the taxpayer's expense in computing cost of service in such ratemaking.

Section 1.167(l)-1(h)(6)(ii) provides that, for the purpose of determining the maximum amount of the reserve to be excluded from the rate base (or to be included as no-cost capital) under subdivision (i), above, if solely an historical period is used to determine depreciation for Federal income tax expense for ratemaking purposes, then the amount of the reserve account for that period is the amount of the reserve (determined under § 1.167(l)-1(h)(2)(i)) at the end of the historical period. If such determination is made by reference both to an historical portion and to a future portion of a period, the amount of the reserve account for the period is the amount of the reserve at the end of the historical portion of the period and a pro rata portion of the amount of any projected increase to be credited or decrease to be charged to the account during the future portion of the period.

Section 1.167(l)-1(h) requires that a utility must maintain a reserve reflecting the total amount of the deferral of federal income tax liability resulting from the taxpayer's use of different depreciation methods for tax and ratemaking purposes. Taxpayer has done so. Section 1.167(l)-1(h)(6)(i) provides that a taxpayer does not use a normalization method of regulated accounting if, for ratemaking purposes, the amount of the reserve for deferred taxes which is excluded from the base to which the taxpayer's rate of return is applied, or which is treated as no-cost capital in those rate cases in which the rate of return is based upon the cost of capital, exceeds the amount of such reserve for deferred taxes for the period used in determining the taxpayer's expense in computing cost of service in such ratemaking. Section 56(a)(1)(D) provides that, with respect to public utility property the Secretary shall prescribe the requirements of a normalization method of accounting for that section.

Section 1.167(l)-1(a)(1) of the Income Tax Regulations provides that the normalization requirements of former § 167(l) with respect to public utility property defined in former § 167(l)(3)(A) pertain only to the deferral of federal income tax liability resulting from the use of an accelerated method of depreciation for computing the allowance for depreciation under § 167 and the use of straight line depreciation for computing tax expense and depreciation expense for purposes of establishing cost of services and for reflecting operating results in regulated books of account.

Section 481(a) requires those adjustments necessary to prevent amounts from being duplicated or omitted to be taken into account when a taxpayer's taxable income is computed under a method of accounting different from the method used to compute taxable income for the preceding taxable year. *See also* § 2.05(1) of Rev. Proc. 97-27,

97-27, 1997-1 C.B. 680 (the operative method change revenue procedure at the time Taxpayer filed its Form 3115, *Application for Change in Accounting Method*).

An adjustment under § 481(a) can include amounts attributable to taxable years that are closed by the period of limitation on assessment under § 6501(a). *Suzy's Zoo v. Commissioner*, 114 T.C. 1, 13 (2000), *aff'd*, 273 F.3d 875, 884 (9th Cir. 2001); *Superior Coach of Florida, Inc. v. Commissioner*, 80 T.C. 895, 912 (1983), *Weiss v. Commissioner*, 395 F.2d 500 (10th Cir. 1968), *Spang Industries, Inc. v. United States*, 6 Cl. Ct. 38, 46 (1984), *rev'd on other grounds* 791 F.2d 906 (Fed. Cir. 1986). *See also Mulholland v. United States*, 28 Fed. Cl. 320, 334 (1993) (concluding that a court has the authority to review the taxpayer's threshold selection of a method of accounting *de novo*, and must determine, *ab initio*, whether the taxpayer's reported income is clearly reflected).

Sections 481(c) and 1.481-4 provide that the adjustment required by § 481(a) may be taken into accounting in determining taxable income in the manner, and subject to the conditions, agreed to by the Service and a taxpayer. Section 1.446-1(e)(3)(i) authorizes the Service to prescribe administrative procedures setting forth the limitations, terms, and conditions deemed necessary to permit a taxpayer to obtain consent to change a method of accounting in accordance with § 446(e). *See also* § 5.02 of Rev. Proc. 97-27.

When there is a change in method of accounting to which § 481(a) is applied, § 2.05(1) of Rev. Proc. 97-27 provides that income for the taxable year preceding the year of change must be determined under the method of accounting that was then employed, and income for the year of change and the following taxable years must be determined under the new method of accounting as if the new method had always been used.

Regarding ruling requests 1 and 2, the key factors in determining whether property is public utility property are that (1) the property must be used predominantly in the trade or business of the furnishing or sale of, inter alia, water and wastewater; (2) the rates for such furnishing or sale must be established or approved by a State or political subdivision thereof, any agency or instrumentality of the United States, or by a public service or public utility commission or similar body of any State or political subdivision thereof; and (3) the rates so established or approved must be determined on a rate-of-return basis. State B statutes and Commission B rules provide eligible water corporations with the ability to recover certain infrastructure system replacement costs outside of a formal rate case filing via a Surcharge. These infrastructure system replacements will be predominantly used in the trade or business of the furnishing or sale of water and wastewater and therefore, it will possess the first of the three characteristics. Moreover, as a regulated public utility subject to the jurisdiction of federal or state law, including the ratemaking jurisdiction of the State B commission, the second requirement is met. Lastly, as evidenced by the facts, these rates are determined on a rate-of-return basis. After establishing that this involves public utility property, the law makes clear that the depreciation deduction determined under § 168

shall not apply to any public utility property if the taxpayer does not use a normalization method of accounting. The normalization regulations require a taxpayer to credit this amount of deferred taxes to a reserve for deferred taxes, a depreciation reserve, or other reserve account.

Taxpayer's ruling request 3 pertains to the depreciation-related ADIT existing prior to the year of change ( ) for public utility property in service as of the end of the taxable year immediately preceding the year of change. Beginning with the year of change, the Consent Agreement granted Taxpayer permission to change its (1) method of accounting for costs to repair and maintain tangible property from capitalizing and depreciating these costs to deducting these costs under § 162, and (2) unit of property for determining dispositions of depreciable network assets from using a method other than the functional interdependence test to using the functional interdependence test to determine the units of property.

As stated previously, condition nine of the Consent Agreement provides that if any item of property subject to the Form 3115 is public utility property within the meaning of § 168(i)(10), a normalization method of accounting (within the meaning of § 168(i)(9)) must be used for such public utility property. Public utility property (within the meaning of § 168(i)(10)) is a depreciable asset. Consequently, condition nine of the Consent Agreement is intended to apply to Taxpayer's public utility property that continues to be depreciated for federal income tax purposes under Taxpayer's new method of accounting for the year of change and subsequent taxable years.

When there is a change in method of accounting to which § 481(a) is applied, income for the taxable year preceding the year of change must be determined under the method of accounting that was then employed by Taxpayer, and income for the year of change and the following taxable years must be determined under Taxpayer's new method of accounting as if the new method had always been used. *See* § 481(a); § 1.481-1(a)(1); and § 2.05(1) of Rev. Proc. 97-27. In other words: (1) Taxpayer's new method of accounting is implemented beginning in the year of change; (2) Taxpayer's old method of accounting used in the taxable years preceding the year of change is not disturbed; and (3) Taxpayer takes into account a § 481(a) adjustment in computing taxable income to offset any consequent omissions or duplications.

Accordingly, for public utility property in service as of the end of the taxable year immediately preceding the year of change ( ), the depreciation-related ADIT existing prior to the year of change for the changes in methods of accounting subject to the Consent Agreement does not remain subject to the normalization method of accounting within the meaning of § 168(i)(9) after implementation of the new tax methods of accounting in the year of change and subsequent taxable years.

As stated previously under ruling request 3, condition nine of the Consent Agreement is intended to apply to Taxpayer's public utility property that continues to be depreciated for federal income tax purposes under Taxpayer's new method of

accounting for the year of change and subsequent taxable years. A repair expense is an item of expense that is deductible under § 162 and for which depreciation is not allowable. Accordingly, the ADIT resulting from the repair-related § 481(a) adjustment is not subject to the normalization method of accounting within the meaning of § 168(i)(9).

Similarly, condition nine of the Consent Agreement is intended to apply to Taxpayer's public utility property that continues to be depreciated for federal income tax purposes under Taxpayer's new method of accounting for the year of change and subsequent taxable years. A repair expense is an item of expense that is deductible under § 162 and for which depreciation is not allowable. Accordingly, ADIT resulting from expenditures (1) related to an item of property includible in rate base and recoverable as regulatory depreciation expense in the determination of the revenue requirement set in the Surcharge Case and (2) deducted as repairs under § 162 to public utility property within the meaning of § 168(i)(10), or a predecessor provision of the normalization requirements, pursuant to the tax method of accounting for repairs permitted in Taxpayer's Consent Agreement, is not subject to the normalization method of accounting within the meaning of § 168(i)(9) or, as applicable, a predecessor statutory provision.

Regarding ruling request 6, § 1.167(l)-1(a)(1) provides that the normalization requirements for public utility property pertain only to the deferral of federal income tax liability resulting from the use of an accelerated method of depreciation for computing the allowance for depreciation under § 167 and the use of straight-line depreciation for computing tax expense and depreciation expense for purposes of establishing cost of services and for reflecting operating results in regulated books of account. Section 1.167(l)-1(h)(1)(i) provides that the reserve established for public utility property should reflect the total amount of the deferral of federal income tax liability resulting from the taxpayer's use of different depreciation methods for tax and ratemaking purposes. Section 1.167(l)-1(h)(2)(i) provides that the taxpayer must credit this amount of deferred taxes to a reserve for deferred taxes, a depreciation reserve, or other reserve account. This regulation further provides that, with respect to any account, the aggregate amount allocable to deferred tax under § 167(1) shall not be reduced except to reflect the amount for any taxable year by which Federal income taxes are greater by reason of the prior use of different methods of depreciation. That section also notes that the aggregate amount allocable to deferred taxes may be reduced to reflect the amount for any taxable year by which federal income taxes are greater by reason of the prior use of different methods of depreciation under § 1.167(l)-1(h)(1)(i) or to reflect asset retirements or the expiration of the period for depreciation used for determining the allowance for depreciation under § 167(a). In this case, the transaction involves a replacement or relocation that is not treated as a disposition under Taxpayer's tax method of accounting. The depreciation-related ADIT existing immediately prior to a transaction considered a retirement for regulatory accounting purposes but not treated as a disposition for federal income tax purposes continues to be subject to the

normalization requirements because adjusted tax basis is not affected and the § 168(a) depreciation deductions continue.

For ruling request 7, as stated previously under ruling request 3, condition nine of the Consent Agreement is intended to apply to Taxpayer's public utility property that continues to be depreciated for federal income tax purposes under Taxpayer's new method of accounting for the year of change and subsequent taxable years. Accordingly, the ADIT resulting from the disposition-related § 481(a) adjustment and related to the restored tax basis of public utility property that was treated as disposed under the old method of accounting but is not treated as disposed under the new method of accounting is subject to the normalization method of accounting within the meaning of § 168(i)(9).

Regarding ruling requests 8, 9, and 11, generally, Taxpayer is arguing that the ADIT balance should be reduced by the amounts that Taxpayer calculates did not actually defer tax during the Surcharge Case test period due to the presence of the NOLC. The normalization requirements pertain **only** to deferred income taxes for public utility property resulting from the use of accelerated depreciation for tax purposes and the use of straight-line depreciation for establishing cost of service and reflecting the operating results in regulated books of account. Generally, amounts that do not actually defer tax because of the existence of an NOL need to be reflected as offsetting entries to the ADIT account to show the portion of tax losses which did not actually defer tax due to accelerated depreciation.

Section 1.167(l)-1(h)(6)(i) provides that a taxpayer does not use a normalization method of regulated accounting if, for ratemaking purposes, the amount of the reserve for deferred taxes which is excluded from the base to which the taxpayer's rate of return is applied, or which is treated as no-cost capital in those rate cases in which the rate of return is based upon the cost of capital, exceeds the amount of such reserve for deferred taxes for the period used in determining the taxpayer's expense in computing cost of service in such ratemaking. Because the reserve account for deferred taxes (ADIT), reduces rate base, it is clear that the portion of the net operating loss carryover (NOLC) that is attributable to accelerated depreciation must be taken into account in calculating the amount of the ADIT account balance. Thus, the ADIT asset resulting from the NOLC should be included in rate base, given the inclusion in rate base of the full amount of the ADIT liability resulting from accelerated tax depreciation.

Section 1.167(l)-1(h)(1)(iii) makes clear that the effects of an NOLC must be taken into account for normalization purposes. Section 1.167(l)-1(h)(1)(iii) provides generally that, if, in respect of any year, the use of other than regulatory depreciation for tax purposes results in an NOLC carryover (or an increase in an NOLC which would not have arisen had the taxpayer claimed only regulatory depreciation for tax purposes), then the amount and time of the deferral of tax liability shall be taken into account in such appropriate time and manner as is satisfactory to the district director. The "with or without" methodology suggested by Taxpayer is specifically designed to ensure that the

portion of the NOLC attributable to accelerated depreciation is correctly taken into account by maximizing the amount of the NOLC attributable to accelerated depreciation. This methodology provides certainty and prevents the possibility of "flow through" of the benefits of accelerated depreciation to ratepayers.

Taxpayer also raises the issue of the computation of the amount by which depreciation-related Taxpayer's NOLC as of the rate base determination date for the Surcharge Case must be included in rate base. This focuses on whether the NOLC taken into account in the Surcharge Case is limited to depreciation-related book/tax differences related to expenditures reflected in the Surcharge Case or must also reflect the full net increase in depreciation-related NOLC occurring since the rate base determination date of the immediately preceding base rate proceeding. In this case, based on the State B statute, the revenue requirement of a Surcharge Case is limited to the following income tax amounts: ADIT associated with property-related costs for property with rates set by the Surcharge Case and income taxes applicable to the Surcharge Case revenue requirement. The normalization requirements do not require that all incremental NOLC arising since the most recent general rate proceeding must be reflected in an interim (here a Surcharge) proceeding. Instead, the normalization requirements permit an increase in NOLC resulting from non-Surcharge Case public utility property to be disregarded for the Surcharge Case and considered in the next rate proceeding that reflects the depreciation expense and rate base inclusion of the public utility property resulting in the depreciation-related book/tax differences included in the NOLC.

Based on the foregoing, we conclude that:

1) The property otherwise depreciable under § 168(a) and for which cost recovery and return on investment initially occur as part of the Surcharge Case, rather than as part of base rates set in less frequent general rate case proceedings, constitutes public utility property within the meaning of § 168(i)(10).

2) The ADIT amounts used in computing the revenue requirement set in the Surcharge Case with respect to public utility property within the meaning of § 168(i)(10) must comply with the normalization method of accounting within the meaning of § 168(i)(9).

3) For any public utility property within the meaning of § 168(i)(10) of the Code as of the end of the tax year immediately preceding the year of change for the changes in tax method of accounting subject to Taxpayer's Consent Agreement, the depreciation-related ADIT prior to the change in tax method of accounting for repairs and dispositions is not subject to the normalization method of accounting within the meaning of § 168(i)(9) of the Code after implementation of the new tax method of accounting.

4) For any public utility property within the meaning of § 168(i)(10) and subject to Taxpayer's Consent Agreement, the ADIT resulting from the repair-related § 481(a)

adjustment is not subject to the normalization method of accounting within the meaning of § 168(i)(9).

5) The ADIT resulting from expenditures (1) related to an item of property includible in rate base and recoverable as regulatory depreciation expense in the determination of the revenue requirement set in the Surcharge Case and (2) deducted as repairs under § 162 to public utility property within the meaning of § 168(i)(10), or a predecessor provision of the normalization requirements, pursuant to the tax method of accounting for repairs permitted in Taxpayer's Consent Agreement, is not subject to the normalization method of accounting within the meaning of § 168(i)(9) or, as applicable, a predecessor statutory provision.

6) The ADIT resulting from book/tax differences related to depreciable method and life for public utility property that exists at the date of a retirement of the property for regulatory accounting purposes in a transaction involving a replacement or relocation that is not treated as a disposition under Taxpayer's tax method of accounting for dispositions permitted in Taxpayer's Consent Agreement remains subject to the normalization method of accounting within the meaning of § 168(i)(9) after the book-only retirement.

7) For any public utility property within the meaning of § 168(i)(10) for which a disposition had been recognized for tax purposes in a tax year prior to the tax year of change for the changes in tax method of accounting subject to Taxpayer's Consent Agreement and for which the taxable gain or loss upon such disposition was reversed as part of the disposition-related § 481(a) adjustment, the ADIT related to the restored tax basis of such public utility property is subject to the normalization method of accounting within the meaning of § 168(i)(9), despite the book-only retirement.

8) In order to comply with the normalization method of accounting within the meaning of § 168(i)(9), the amount of depreciation-related ADIT reducing rate base used to determine the revenue requirement set in the Surcharge Case is limited to the amount of depreciation-related deferred tax expense recovered in rates as of the Surcharge Case rate base determination date.

9) Under the circumstances described, in order to comply with the normalization method of accounting within the meaning of § 168(i)(9), the amount of depreciation-related ADIT reducing rate base used to determine the revenue requirement set in the Surcharge Case must be decreased to reflect a portion of the NOL for the test period for the Surcharge Case which would not have arisen had Taxpayer not reported depreciation-related book/tax differences during the text period for the Surcharge Case and such decrease in depreciation-related ADIT must be an amount that is no less than the amount computed using the With-and-Without Method.

10) Ruling request 10 is moot because we grant ruling 9 in accordance with Taxpayer's analysis.

11) Under the circumstances described above, in order to comply with the normalization method of accounting within the meaning of § 168(i)(9), it is not necessary to decrease ADIT or otherwise increase rate base for the Surcharge Case by the portion of the NOLC which would not have arisen (or an increase in such NOLC which would not have arisen) had Taxpayer not reported depreciation-related book/tax differences in prior periods or during the test period for the Surcharge Case with respect to public utility property with rates not set by the Surcharge Case.

12) Ruling request 12 is moot because we rule as Taxpayer requests with respect to ruling request 5.

Except as specifically set forth above, no opinion is expressed or implied concerning the federal income tax consequences of the above described facts under any other provision of the Code or regulations.

This ruling is directed only to the taxpayer requesting it. Section 6110(k)(3) of the Code provides that it may not be used or cited as precedent.

This ruling is based upon information and representations submitted by Taxpayer and accompanied by penalty of perjury statements executed by an appropriate party. While this office has not verified any of the material submitted in support of the request for rulings, it is subject to verification on examination.

In accordance with the power of attorney on file with this office, a copy of this letter is being sent to your authorized representatives.

Sincerely,

Patrick S. Kirwan
Chief, Branch 6
Office of Associate Chief Counsel
(Passthroughs & Special Industries)

Internal Revenue Service

Department of the Treasury
Washington, DC 20224

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Date of Communication: Not Applicable

Person To Contact:
, ID No.

Telephone Number:

Refer Reply To:
CC:PSI:B06
PLR-119555-21

Date:
March 24, 2022

In Re:

LEGEND:

Taxpayer =

Parent =

State =
Commission =
Date 1 =
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Date 10 =
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Dear :

This letter responds to a request for a private letter ruling dated September 22, 2021, and additional submission dated November 19, 2021, submitted on behalf of Taxpayer for rulings under § 168(i)(9) of the Internal Revenue Code and § 1.167(l)-1 of the Income Tax Regulations regarding the application of the deferred tax normalization requirements and the appropriate methodology for the reduction of the accumulated deferred income tax ("ADIT") balance that decreases rate base computation when a net operating loss carryforward ("NOLC") exists. An earlier letter ruling (PLR 202010002, dated December 3, 2019, "2020 Ruling") to Taxpayer addressed this issue, but judicial and regulatory developments since the issuance of the 2020 Ruling have clarified pertinent regulatory matters and must be taken into account to apply the normalization rules.

Taxpayer's representations in the earlier letter ruling and those in the current request are as follows:

Taxpayer is a water and wastewater utility company that operates in State with rates set by Commission for the furnishing or sale of water or sewage disposal services through a combination of periodic general rate case proceedings (resulting in what are commonly referred to as "base rates") and infrastructure surcharge proceedings (resulting in surcharges that are added to base rates).

Under State statute and Commission rulemaking, eligible water corporations may petition Commission and utilize an Infrastructure System Replacement Surcharge ("Surcharge") to recover the costs of eligible water utility main replacements and relocations.

For both general rate case proceedings and Surcharge proceedings, Taxpayer computes a revenue requirement subject to Commission approval based on recovery of a debt- and equity-based return on investment in rate base, including the cost of plant assets less accumulated book depreciation and ADIT, and a recovery of operating

expenses, including depreciation expense, property tax expense, and income tax expense.

A State statute authorizes Commission to enter an order authorizing the water corporation to impose a Surcharge that is sufficient to recover "appropriate pretax revenues." The State statute defines the revenue requirement set in a Surcharge proceeding and provides that "appropriate pretax revenues" are "the revenues necessary to produce net operating income equal to . . . the water corporation's weighted cost of capital multiplied by the net original cost of eligible infrastructure system replacements, including recognition of accumulated deferred income taxes and accumulated depreciation associated with eligible infrastructure system replacements . . . " among other items.

In the request resulting in the 2020 Ruling, Taxpayer represented that Commission and the State courts have interpreted this statute in a strict manner thereby limiting the costs eligible for recovery or to earn a return in a Surcharge proceeding and causing costs not eligible for ratemaking consideration in a Surcharge proceeding to only be eligible for recovery or return in the next base rate proceeding. As described below, a court decision after issuance of the 2020 Ruling has clarified the applicable interpretation of this statute.

The deferred tax normalization matters in the original request and in this request pertain to the Surcharge proceeding initiated by Taxpayer in Month 1 Year 1 (the "Surcharge Case") and resulting in a Commission order on Date 1 (the "Date 1 Order"). The Surcharge Case relates to additions of certain property placed in service from Date 2 through Date 3 and accumulated depreciation and estimated ADIT on such assets was through Date 4. The Surcharge resulting from the Surcharge Case became effective on Date 5.

On a consolidated basis, Parent incurred tax losses in various years from Year 2 to Year 3 and, as of Date 6, had an NOLC of approximately $a. On a separate company basis, Taxpayer incurred tax losses in various tax years from Year 2 to Year 4 and, as of Date 6, had a separate company NOLC of approximately $b (after tax-sharing payments). For Year 1, Parent (on a consolidated basis) and Taxpayer (on a separate company basis) estimated and then ultimately reported that taxable income was earned and, thus, NOLC was utilized.

As of the date of the rate base determination (Date 4), a taxable loss of approximately $c had been incurred with respect to the plant-related expenditures with rates set by the Surcharge Case and associated Surcharge revenues as of such date. However, Taxpayer reported taxable income for the tax year that included the Surcharge Case test period on the basis of all of the gross income and deductions from Commission-regulated operations.

The NOLC reflected in ratemaking for the base rate case proceeding with rates effective in Month 2 Year 1 was based on the estimated NOLC as of the end of Year 4

of $d, including an estimated Year 4 tax loss of $e. The actual Year 4 tax loss reported on the Year 4 tax return was $f. The excess of the actual Year 4 tax loss over the estimated Year 4 tax loss had yet to be reflected in ratemaking at the time of the Surcharge Case but was reflected in the subsequent base rate case.

Issues disputed by participants in the Surcharge Case included whether the tax effect of an NOLC must, pursuant to the normalization requirements, decrease the ADIT reduction to rate base related to the expenditures in the Surcharge Case and, if so, the methodology to determine the amount of the NOLC adjustment subject to the normalization requirements. The revenue requirement approved in Commission's Date 1 Order was lower than the revenue requirement sought by Taxpayer and is entirely attributable to differing ADIT calculations with respect to the NOLC and the resulting effects on rate base and allowed return. The approved revenue requirement in the Surcharge case was based on a rate base computation that reflects the gross ADIT liabilities associated with depreciation-related and repair-related book/tax differences, but did not reflect an ADIT asset for any portion of Taxpayer's NOLC as of the date that rate base was determined (Date 4), including the tax loss resulting from the infrastructure expenditures addressed in the Surcharge Case.

On Date 7, Taxpayer filed an Application for Rehearing and Motion to Defer Ruling, asking the Commission for the time to seek a private letter ruling form of guidance from the Service to address any uncertainties regarding the application of the deferred tax normalization requirements to the rate base treatment of the NOLC-related ADIT asset in computing the Surcharge case revenue requirement. On Date 8, the Commission denied Taxpayer's request for rehearing. Taxpayer filed a notice of appeal by Date 9, that initiated an appeal of the order in the Surcharge case to the State Court of Appeals. Taxpayer filed a private letter ruling request that resulted in the 2020 Ruling.

Taxpayer received the 2020 Ruling on Date 10 and notified the Commission that it had been received by way of correspondence dated Date 11.

On Date 12, Taxpayer filed a petition with Commission seeking to establish a Surcharge rate to provide for the recovery of costs for eligible infrastructure system replacements and relocations for a test period that included such date. In addition, Taxpayer sought to recover the incremental revenue requirement associated with the Surcharge Case attributable to the holdings of the 2020 Ruling.

As part of this Surcharge proceeding, Commission Staff filed its recommendation and memorandum agreeing with Taxpayer's calculations and recommending the Commission approve Taxpayer's requested rate changes including an adjustment related to the NOLC normalization matter in the Surcharge Case and subsequent Surcharge proceedings prior to the Surcharge proceeding initiated on Date 12. Another participant in the regulatory proceeding filed its objections and a request for an evidentiary hearing. The Commission conducted an evidentiary hearing and issued an

order on Date 13 with respect to this Surcharge proceeding ("Date 13 Order") that permitted the rate recovery sought by Taxpayer with respect to the NOLC-related normalization matter addressed in the 2020 Ruling for the periods covered by the Surcharge Case and subsequent Surcharge proceedings prior to the Surcharge proceeding initiated on Date 12.

The participant in the regulatory proceeding that had filed objections during this Surcharge proceeding subsequently filed a motion for rehearing related to the Date 13 Order. The Commission denied the application for rehearing. This participant then filed a Notice of Appeal with Commission and initiated litigation against the Commission and Taxpayer in the State Court of Appeals with respect to the Date 13 Order.

On Date 14, the State Court of Appeals rendered an opinion requiring the Commission to reduce its revenue requirement calculation for the Surcharge Case to eliminate the component attributable to the NOLC-related normalization matter ("Date 14 Decision"). The State Court of Appeals held that the Commission misinterpreted holding 9 of the 2020 Ruling and further held that whether an NOL exists for a test period is based on the entirety of the taxpayer's Commission-regulated operations, not simply the gross income and deductions for a particular Surcharge proceeding. The Date 14 Decision remands the Date 13 Order to the Commission and orders reduction of Taxpayer's computation of rate base for the Surcharge Case by reflecting depreciation-related ADIT subject to the deferred tax normalization requirements without reduction for Taxpayer's NOLC.

On Date 15, Taxpayer filed an Application for Rehearing or Motion to Transfer with State Court of Appeals, asking that the Court rehear the matter or, in the alternative, transfer the case to the State Supreme Court. On Date 16, the State Court of Appeals denied the motion for rehearing and denied transfer of the case to the State Supreme Court.

On Date 17, Taxpayer filed an Application for Transfer to the State Supreme Court and on Date 18, the State Supreme Court denied the application. Taxpayer has no further avenues to appeal the Date 14 Decision.

In accordance with the Date 14 Decision, the Date 13 Order was remanded back to Commission, and Commission had 60 days (subject to extension) to issue a revised order. At the time this ruling request was submitted to this office, Taxpayer expected Commission to comply with the Date 14 Decision and revise the Surcharge Case revenue requirement computation in a manner contradictory to holding 9 of the 2020 Ruling. On Date 19, Commission issued an order on remand, effective Date 20, with respect to the rate refund resulting from the Date 14 Decision. As expected, the Commission ordered Taxpayer to refund amounts that were previously recovered from customers in accordance with the original interpretation by Taxpayer and the Commission of holding 9 of the 2020 Ruling. Taxpayer intends to set prices in accordance with this order.

Holding 9 of the 2020 Ruling was premised on Taxpayer's interpretation of the statute and applicable regulatory and judicial precedent that considered Taxpayer's NOLC to be increasing during the Surcharge Case test period for purposes of setting the Surcharge. Based on the clarification provided by the Date 14 Decision, Taxpayer submitted a revision to its facts represented in the earlier ruling request to reflect that Taxpayer is instead considered to have decreased its NOLC during the Surcharge Case test period for purposes of setting the Surcharge. Thus, the analysis resulting in holding 9 of the 2020 Ruling must be reconsidered.

RULINGS REQUESTED

Taxpayer requests that the Service rule:

Under the circumstances described, in order to comply with the normalization method of accounting within the meaning of § 168(i)(9), the amount of depreciation-related ADIT reducing rate base used to determine the revenue requirement set in the Surcharge Case is not required to be decreased to reflect any portion of Taxpayer's NOLC existing during the test period for the Surcharge Case because Taxpayer expected to decrease its NOLC during the Surcharge Case test period and the remaining depreciation-related NOLC was reflected in ADIT used to compute rate base in the base rate proceedings immediately preceding and immediately subsequent to the Surcharge Case.

LAW AND ANALYSIS

Section 168(f)(2) of the Code provides that the depreciation deduction determined under § 168 shall not apply to any public utility property (within the meaning of § 168(i)(10)) if the taxpayer does not use a normalization method of accounting.

In order to use a normalization method of accounting, § 168(i)(9)(A)(i) of the Code requires the taxpayer, in computing its tax expense for establishing its cost of service for ratemaking purposes and reflecting operating results in its regulated books of account, to use a method of depreciation with respect to public utility property that is the same as, and a depreciation period for such property that is not shorter than, the method and period used to compute its depreciation expense for such purposes. Under § 168(i)(9)(A)(ii), if the amount allowable as a deduction under § 168 differs from the amount that would be allowable as a deduction under § 167 using the method, period, first and last year convention, and salvage value used to compute regulated tax expense under § 168(i)(9)(A)(i), the taxpayer must make adjustments to a reserve to reflect the deferral of taxes resulting from such difference.

Former § 167(l) of the Code generally provided that public utilities were entitled to use accelerated methods for depreciation if they used a “normalization method of accounting.” A normalization method of accounting was defined in former § 167(l)(3)(G)

in a manner consistent with that found in § 168(i)(9)(A). Section 1.167(l)-1(a)(1) of the Regulations provides that the normalization requirements for public utility property pertain only to the deferral of federal income tax liability resulting from the use of an accelerated method of depreciation for computing the allowance for depreciation under § 167 and the use of straight-line depreciation for computing tax expense and depreciation expense for purposes of establishing cost of services and for reflecting operating results in regulated books of account. These regulations do not pertain to other book-tax timing differences with respect to state income taxes, F.I.C.A. taxes, construction costs, or any other taxes and items.

Section 1.167(l)-1(h)(1)(i) provides that the reserve established for public utility property should reflect the total amount of the deferral of federal income tax liability resulting from the taxpayer's use of different depreciation methods for tax and ratemaking purposes.

Section 1.167(l)-1(h)(1)(iii) provides that the amount of federal income tax liability deferred as a result of the use of different depreciation methods for tax and ratemaking purposes is the excess (computed without regard to credits) of the amount the tax liability would have been had the depreciation method for ratemaking purposes been used over the amount of the actual tax liability. This amount shall be taken into account for the taxable year in which the different methods of depreciation are used. If, however, in respect of any taxable year the use of a method of depreciation other than a subsection (l) method for purposes of determining the taxpayer's reasonable allowance under § 167(a) results in a NOL carryover to a year succeeding such taxable year which would not have arisen (or an increase in such carryover which would not have arisen) had the taxpayer determined his reasonable allowance under § 167(a) using a subsection (l) method, then the amount and time of the deferral of tax liability shall be taken into account in such appropriate time and manner as is satisfactory to the district director.

Section 1.167(l)-1(h)(2)(i) provides that the taxpayer must credit this amount of deferred taxes to a reserve for deferred taxes, a depreciation reserve, or other reserve account. This regulation further provides that, with respect to any account, the aggregate amount allocable to deferred tax under § 167(l) shall not be reduced except to reflect the amount for any taxable year by which Federal income taxes are greater by reason of the prior use of different methods of depreciation. That section also notes that the aggregate amount allocable to deferred taxes may be reduced to reflect the amount for any taxable year by which federal income taxes are greater by reason of the prior use of different methods of depreciation under § 1.167(l)-1(h)(1)(i) or to reflect asset retirements or the expiration of the period for depreciation used for determining the allowance for depreciation under § 167(a).

Section 1.167(l)-(h)(6)(i) provides that, notwithstanding the provisions of subparagraph (1) of § 1.167(l)-(h), a taxpayer does not use a normalization method of regulated accounting if, for ratemaking purposes, the amount of the reserve for deferred

taxes under § 167(l) which is excluded from the base to which the taxpayer's rate of return is applied, or which is treated as no-cost capital in those rate cases in which the rate of return is based upon the cost of capital, exceeds the amount of such reserve for deferred taxes for the period used in determining the taxpayer's expense in computing cost of service in such ratemaking.

Section 1.167(l)-(h)(6)(ii) provides that, for the purpose of determining the maximum amount of the reserve to be excluded from the rate base (or to be included as no-cost capital) under subdivision (i) of § 1.167(l)-(h)(6), above, if solely an historical period is used to determine depreciation for Federal income tax expense for ratemaking purposes, then the amount of the reserve account for that period is the amount of the reserve (determined under § 1.167(l)-1(h)(2)(i)) at the end of the historical period. If such determination is made by reference both to an historical portion and to a future portion of a period, the amount of the reserve account for the period is the amount of the reserve at the end of the historical portion of the period and a pro rata portion of the amount of any projected increase to be credited or decrease to be charged to the account during the future portion of the period.

Therefore, § 1.167(l)-1(h) requires that a utility must maintain a reserve reflecting the total amount of the deferral of federal income tax liability resulting from the taxpayer's use of different depreciation methods for tax and ratemaking purposes.

The normalization requirements pertain only to deferred income taxes for public utility property resulting from the use of accelerated depreciation for tax purposes and the use of straight-line depreciation for establishing cost of service and reflecting the operating results in regulated books of account. Generally, amounts that do not actually defer tax because of the existence of an NOL need to be reflected as offsetting entries to the ADIT account to show the portion of tax losses which did not actually defer tax due to accelerated depreciation.

Section 1.167(l)-1(h)(6)(i) provides that a taxpayer does not use a normalization method of regulated accounting if, for ratemaking purposes, the amount of the reserve for deferred taxes which is excluded from the base to which the taxpayer's rate of return is applied, or which is treated as no-cost capital in those rate cases in which the rate of return is based upon the cost of capital, exceeds the amount of such reserve for deferred taxes for the period used in determining the taxpayer's expense in computing cost of service in such ratemaking. Because the reserve account for deferred taxes (ADIT), reduces rate base, it is clear that the portion of the NOLC that is attributable to accelerated depreciation must be taken into account in calculating the amount of the ADIT account balance. Thus, the ADIT asset resulting from the NOLC should be included in rate base, given the inclusion in rate base of the full amount of the ADIT liability resulting from accelerated tax depreciation.

Section 1.167(l)-1(h)(1)(iii) makes clear that the effects of an NOLC must be taken into account for normalization purposes. Section 1.167(l)-1(h)(1)(iii) provides

generally that, if, in respect of any year, the use of other than regulatory depreciation for tax purposes results in an NOLC carryover (or an increase in an NOLC which would not have arisen had the taxpayer claimed only regulatory depreciation for tax purposes), then the amount and time of the deferral of tax liability shall be taken into account in such appropriate time and manner as is satisfactory to the district director.

At issue in the Surcharge Case is the computation of the amount by which Taxpayer's NOLC as of the rate base determination date for the Surcharge Case is attributable to depreciation-related book/tax differences pertaining to expenditures for public utility property which are reflected in the Surcharge Case and subject to § 1.167(l)-1(h)(1)(iii). Based on the State statute and judicial decisions, whether an NOL exists for a Surcharge proceeding test period and, thus, whether an overall NOLC existing prior to such test period is increasing or decreasing during a Surcharge proceeding test period are based on gross income and deductions related to all of Taxpayer's Commission-regulated operations during such test period and are not limited to the gross income and deductions pertaining to the Surcharge Case in isolation.

Taxpayer has indicated that all of the property placed in service in the test period for the Surcharge Case was placed in service in Year 1. During Year 1, gross income of Taxpayer exceeded deductions allowed of Taxpayer and, thus, an NOL as defined in § 172(c) of the Code did not occur. Similarly, gross income of the consolidated group exceeded deductions allowed of the consolidated group and, thus, an NOL as defined in § 172(c) of the Code did not occur on a consolidated basis either. Accordingly, during Year 1, both Taxpayer and its consolidated group utilized a portion of their NOLCs existing at the end of Year 4. No portion of the NOLC of Taxpayer at the beginning or end of the test period for the Surcharge Case is attributable to depreciation of public utility property with rates set in the Surcharge Case. Instead, depreciation of Surcharge Case public utliity property reduced current-year (Year 1) taxable income.

On this basis, taxable income rather than an NOL resulted during the Surcharge Case test period and, thus, Taxpayer's NOLC decreased during the Surcharge Case test period. The NOLC normalization requirement of § 1.167(l)-1(h)(1)(iii) does not apply to depreciation-related book/tax differences pertaining to expenditures for public utility property reflected in the Surcharge Case because Taxpayer's NOLC did not arise or increase due to the Surcharge Case depreciation-related book/tax differences with respect to public utility property. Significantly, Taxpayer's depreciation-related NOLC is reflected in the ADIT amount used to compute rate base in the base rate proceedings immediately preceding and immediately subsequent to the Surcharge Case.

CONCLUSION

Based on the foregoing, we conclude as follows:

Under the circumstances described, in order to comply with the normalization method of accounting within the meaning of § 168(i)(9), the amount of depreciation-related ADIT reducing rate base used to determine the revenue requirement set in the Surcharge Case is not required to be decreased to reflect any portion of Taxpayer's NOLC existing during the test period for the Surcharge Case because Taxpayer expected to decrease its NOLC during the Surcharge Case test period and the remaining depreciation-related NOLC was reflected in ADIT used to compute rate base in the base rate proceedings immediately preceding and immediately subsequent to the Surcharge Case.

Except as specifically set forth above, no opinion is expressed or implied concerning the federal income tax consequences of the above described facts under any other provision of the Code or regulations.

This ruling is directed only to the taxpayer requesting it. Section 6110(k)(3) of the Code provides that it may not be used or cited as precedent.

This ruling is based upon information and representations submitted by Taxpayer and accompanied by penalty of perjury statements executed by an appropriate party. While this office has not verified any of the material submitted in support of the request for rulings, it is subject to verification on examination.

In accordance with the power of attorney on file with this office, a copy of this letter is being sent to your authorized representative.

Sincerely,

/S/

Patrick S. Kirwan
Chief, Branch 6
Office of the Associate Chief Counsel
(Passthroughs and Special Industries)

Enclosure:
Copy for § 6110 purposes

cc: